

NAVAL POSTGRADUATE SCHOOL

Monterey, California



THESIS

**MALAYSIAN ECONOMIC CRISIS: CAUSES, EFFECTS,
RECOVERY ACTIONS AND LESSONS LEARNED**

by

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ACTIONS, AND LESSONS LEARNED**

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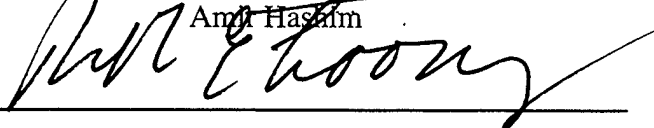
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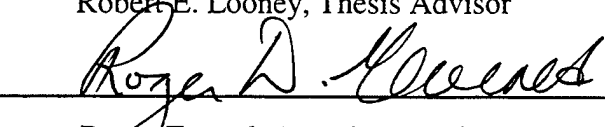
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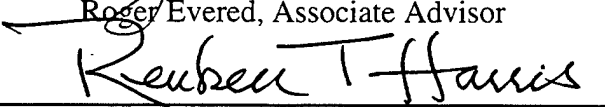
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ABSTRACT

Malaysia and several East Asian economies have been caught in the grip of the currency crisis that started in July 1997. At the start of the crisis, Malaysia adopted a tight fiscal and monetary policy in response of the economic environment prevailing at that time. It was obvious that the initial policy package resulted in severe economic contraction and deterioration in the health of the financial system. In response, the Government unveiled the National Economic Recovery Plan (NERP) which recommended a complete reversal of key policies. The NERP called for an easing of fiscal and monetary policy, an increase in government spending, corporate debt restructuring, and establishment of special vehicles to purchase and recapitalize non-performing loans from banking institutions. On September 1, 1998 the Government introduced capital controls and pegged the exchange rate to the US dollar, in order to insulate the domestic interest rate from continuing pressure and volatility in the foreign exchange market. This thesis explores the measures taken by the Malaysian Government to cope with the recent economic crisis and describes the effects and lessons learned. The proper implementation of the selective capital control has given Malaysia a breathing space to pursue its on-going economic related programs.

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I. INTRODUCTION

A. BACKGROUND

The East Asian financial and economic crisis, which started in July 1997, arose following a sudden large outflow of short-term capital from the domestic financial market. The floating of the Thai baht on the 2 July 1997 marked the onset of the Asian Crisis, which has serious repercussions for the miracle economies of East Asia, for developing countries in general and for financial market worldwide. The Asian Crisis has also generated a heated debate on fundamental issues of economics, finance, and economic policy-making in general.¹

The numerous analyses written on this however have blamed the several weaknesses inherent in many of the Asian economies for the problems. These include the large macroeconomic imbalances and structural weaknesses of the banking sector. The shortcomings and inconsistencies in macroeconomic management and exchange rate policies have also been cited as contributing to the build-up of the crisis. The rapid outward-oriented growth of many countries, particularly in the Asian region, financed by overseas capital and large credit lines extended by the domestic banking system, is reported to have contributed to overheating of these economies leading to an asset bubble

¹ Ha-Joon Chang, Gabriel Palma and Hugh Whittaker, "The Asian Crisis", *Cambridge Journal of Economics* 1998, p.649.

burst. Therefore the outflow is said to be natural phenomenon representing of the market forces.

Malaysia is caught in a severe and prolonged currency crisis that has swept across East Asia. The large-scale movement of funds out of domestic financial markets first started in Thailand before spreading quickly to neighboring countries and South Korea. Faced with mounting financial straits the worsened during the crisis, three countries – Thailand, Indonesia, and South Korea – turned into the International Monetary Fund (IMF) for assistance. The total bailout package amounted to \$118.6 billion, the largest ever bailout arranged under IMF.²

The speed and severity of the contagion effects of the East Asian financial crisis caught many people by surprise. The depreciation of one currency set off corresponding depreciation in the region's currencies. The currency crisis brought about the collapse of the stock market and asset prices. This, in turn, caused the exchange rate to fall further, as business with foreign exposure and people will access the local currencies, follow the trail of the currency speculators to buy foreign currency. They do this as a way of hedging against future loss or even profiting from the currency gyrations.

The fall in the exchange rate and the value of stock hit businesses hard, undermine the financial system, and inflate the size of foreign debt obligations. As a result, businesses in East Asia are badly affected, financial systems undermined, and the size of foreign debt obligations inflated. The crisis has demonstrated how closely the currency

² Shalendra D.Sharma, "Asia Economic Crisis and the IMF", *Survival* (London: Summer 1998).

and the stock markets in the region are interlinked and how the political and economic circumstances of neighboring countries affect one another.

At the early stage of the crisis, foreign analysts and international fund managers had placed Malaysia in the same category with the other countries in the region. The currencies and the stock market were very closely coupled with those of neighboring countries although there is no clear reason why this should be so. It is increasingly become less so now as they begin to recognize Malaysia much stronger economic and financial position, political stability and commitment towards economic recovery.

Since one reason for the currency crisis, is the crisis of confidence, the restoration of confidence would be an important step to tackle the currency crisis. However, restoring confidence is as much a matter of perceptions and social psychology as of realities and economic fundamentals. It is imperative to quickly address the underlying problems – both real and perceived that had set off the crisis. When the economy goes into steep slowdown, the problem faced by corporations will be compounded, and this will place pressure on the financial institutions. However, if the slowdown in growth could be minimized, the corporation and the financial institutions could get into a self-reinforcing virtuous circle that would help to support further economic growth.

B. RESEARCH SCOPE

The financial crisis, which began in mid-1997 with the speculative attack on the East Asian currencies, including the ringgit, has affected all sections of the Malaysian society, individuals as well as businesses. Although the financial crisis has had wide-

ranging effects, particularly in terms of meeting the National Development Policy targets, Malaysia has successfully avoided the extreme effects of the crisis such as high unemployment, mass poverty, massive bankruptcies and civil unrest experienced by some regional economies. This has been made possible by the strong initial conditions, both in terms of real economy and the financial sector as well as the swift and pragmatic measures introduced by the government during the course of the crisis.

Early to the crisis, the government introduced a series of measures believed to be able to deal with the financial crisis and stabilized the economy. They contained elements of the International Monetary Fund's (IMF) prescriptions for other regional economies. This involved, among others, the further tightening of the monetary policy by increasing interest rates and limiting credit growth. The government also exercised greater fiscal restraints by reducing both operating and development expenditure, even though the budget was already in substantial surplus. In addition Central Bank, Bank Negara Malaysia (BNM) introduced several untimely structural reforms in the financial sector. These measures, while addressing some demand pressures, were highly deflationary and had unintended effects. Coupled with the weak external demand and prolonged period of uncertainty in the regional economies, it led to the severe contraction of the economy.

This thesis will focus the financial crisis in Malaysia. To understand the financial turmoil, it is necessary to begin with by looking at the macroeconomic developments in the region up to the middle 1997 and provide an overview of the Asian financial crisis. It will present the fundamental strengths of the Malaysian economy that makes it different from other affected countries, and discuss the causes of the crisis and the effects on Trade

Balance, Manufacturing Exports, Primary Commodities, and Imported Inputs. This thesis will also critically assess the recovery actions taken by the Government based on the National Economic Recovery Plan (NERP) which was formulated to call for an easier fiscal and monetary policy and also the implementation of selective capital control as a measure to stabilize the economy.

C. METHODOLOGY

The methodology used in this thesis is to conduct the literature review on economy and policy aspects from archival research, as well as a literature search of books, magazine articles, internet articles, and other information sources in order to provide appropriate frame of reference and information. All data and information will be analyzed to draw a conclusion.

D. ORGANIZATION OF THE STUDY

Chapter I presents general introduction on East Asian financial and economic crisis and it will follow by scope and guideline of the thesis. Chapter II will give the overview of the Asian Economic Crisis, how it was started and spreading from one country to another. This chapter will also trying to determine the main causes of the turmoil in the region by giving general explanation on the economic performance, weaknesses in macro economic fundamentals, and openness of the capital account. Chapter III will focus on the Financial Crisis in Malaysia. This chapter will give the emphasis on the Malaysia's look prior to the crisis, present the fundamental strengths of

the Malaysian economy and determine the disturbing signs that lead to the crisis. The chapter will also explore on the effects of the crisis on trade balance, manufacturing exports and imported inputs. Chapter IV will concentrate in the actions taken by Malaysian government to fight against the crisis. The actions that will be discussed include the initial stage of recovery actions, which involved Tight Monetary and Fiscal Policies, Financial Sector Restructuring, Measures to improve Capital Market and Selective Capital Control. Chapter V will be Lessons Learned and Conclusion.

II. OVERVIEW OF ASIAN FINANCIAL CRISIS

A. INTRODUCTION

Countries of the Association of South East Asian Nations (ASEAN) and Asian Tigers have been the world's economic miracle for the last thirty years. Singapore, Malaysia, Thailand, and the Philippines have achieved remarkable rates of growth among ASEAN countries, building high-quality manufacturing industries in everything from clothes to computers. The developing ASEAN countries also have forged regional peace and security, vibrant economic growth, and higher level of social welfare, a new issue that is economic security confronted the grouping's economies. Rapid growth of over seven percent per annum achieved during the past decade, which made ASEAN one of the fastest growing region in the world, came to a crashing end because of the financial crisis that hit the region in the second half of 1997. ASEAN's economic growth in 1998 was the lowest in the last three decades.³

However, the factors that contributed to rapid economic expansion in ASEAN countries remained strong, and have potential to return the region's economic back to a sustainable growth path. ASEAN continues to enjoy, for example, high level of saving, a

³ Robert R. Teh Jr., "Green Shoots of Recovery", *Trade Route Asia Pacific 1999*, (Stroudgate, Australia, 1999).

strong work ethic, low underlying inflation rates, strong economic integration, and a dynamic entrepreneurial private sector.⁴

In previous instances of economic-slow downs in the 1980s and 1990s, each ASEAN's country was able to come out relatively unscathed after the restructuring of their industrial sectors. Since then, the region's rapid economic growth, particularly in the real sector, has resulted in the strong demand for capital to finance economic development. This led to large inflows of both long and short-term capital in the region. The development of strong financial institutions both at the regional level and for each ASEAN member country is of crucial importance in order to cope with such large inflows.⁵ The adjustment to the latest crisis will therefore be different from previous ones. The crisis is a region-wide phenomenon and calls for a regional solution. It also involves private debts for which the role of the private sector would be crucial.

B. ASEAN ECONOMIES BEFORE 1997 CRISIS

To understand the financial turmoil it is necessary to begin by looking at macroeconomic developments in the region up to the middle of 1997. The sound macroeconomic fundamentals of ASEAN countries defied any suspicion of the dramatic collapse of exchange rates that began in July 1997. Over the past twenty-five years, ASEAN has been one of the fastest-growing regions in the world. Between the 1970s and

⁴ Rodolfo C. Severino, "Asian on the Road of Recovery" (Paper presented at the Seminar on the Economic Crisis: Road to Recovery, March 8, 1999, Kuala Lumpur, Malaysia).

⁵ Joseph E. Stiglitz, "Some Lessons from East Asian Miracle", *The World Bank Research Observer*, (Washington, August 1996).

1995, the gross domestic product (GDP) of ASEAN countries grew at an average annual rate of 6.6 percent. This is remarkable achievement since other developing countries grew only about three percent during the same period. More remarkable was the fact that the high rates of growth were sustained in the face of major upheavals in the world economy, including the collapse of the Bretton Woods system and the global recession of the early 1980s and early 1990s. Growth actually accelerated in the early 1990s before it peaked in the 1994-95 with Malaysia, Singapore and Thailand enjoying growth rates in the range of 8-10 percent. Even the Philippines, which had been bypassed by the East Asian Miracle, had begun its economic recovery sustained by a decade-long process of reform and liberalization.⁶

During this period, ASEAN countries dramatically transformed and consolidated production structures. Agriculture's share of GDP fell from about 40 percent in the 1960 to 14 percent in 1993. In 1960, industry accounted for only about 20 percent of the GDP. By 1993, this figure had more than doubled. Today, industrial growth in ASEAN has begun to show the hallmarks of modernization and rapid industrialization, with electrical appliances, machinery, chemical, and other manufacturers becoming as important as the cultivation and processing of food, raw materials and textile goods. The force for this transition was enhanced by ASEAN's export-orientation, supplemented by liberalization both within the region and internationally.⁷

⁶ Nayan Chandra, "Rebuilding Asia", *Far Eastern Economic Review*, February 12, 1998, p. 46-48

⁷ Nayan Chandra, "Rebuilding Asia".

The acceleration of growth in the 1960s was generally achieved without generating inflationary pressure. With the exception of the Philippines, inflation in the five ASEAN countries that has gone through beyond transitional economy remained within single digits. Given the GDP growth of about seven percent during this period and the boom in the export sector, maintaining a low level of inflation was quite an achievement.⁸ The clearest sign of macroeconomic stability was that almost all countries ran surpluses through the 1990s. Singapore had traditionally run budgetary surpluses even though it had a low-tax regime. Thailand ran budgetary surpluses for nearly a decade from the mid-1980s. Only the Philippines struggled to bring its fiscal house in order, but in 1996 it managed to run a surplus in the consolidated public sector as a result of the passage of important tax measures between 1993 and 1996 and administrative improvements in tax collection.⁹

The engine of growth for the ASEAN countries was exports. Their exports grew more than fifty-fold, from US\$6.3 billion in 1970 to US\$340 billion in 1996, making in the fourth largest trading region in the world, lagging behind only the European Union, the United States, and Japan. Export growth was strong for most countries until 1996, with Malaysia, Singapore, and Thailand showing exceptional strength. Singapore's exports more than doubled from US\$58.4 billion in 1991 to US\$122.5 billion in 1996.¹⁰

⁸ ASEAN Secretariat, *ASEAN Microeconomic Outlook, 1997-1998* (Jakarta, Indonesia: Academic Press, ASEAN Secretariat, 1998).

⁹ Ibid.

¹⁰ Ibid.

The major concern with the macroeconomic picture in ASEAN was the relatively high current account deficits, especially for Malaysia and Thailand.¹¹ By 1995 the deficits had grown to 8.1 percent of GDP in the case of Thailand and ten percent of GDP for Malaysia. For the most part, the deficits were associated with lumpy investment expenditures and were therefore short term in nature and did not reflect a structural imbalance. Nevertheless, by 1996 most countries were engineering a soft landing for their economies from the perhaps unsustainable boom years of 1994-1995. With the exception of Thailand, current accounts deficits had been reduced to some substantial levels by the end of 1996.¹² The current account deficit by itself is not necessary a sign of structural weakness, since creditors who provide the financing must be convinced by the positive prospects of adequate returns on their investments.

In short, the macroeconomic evidence gave very little hint of the coming crisis. This suggested that the financial meltdown of the region had roots substantially different from the past financial crises within and outside the region. In Latin America, lack of public sector discipline and unsustainable and unproductive financing of public projects through sovereign debt were the root cause of macroeconomic upheavals.¹³

¹¹ Robert McKee, *Thailand: Classic Mistake*. Available at <http://www.megastories.com/seasia/thailand/thailand2.htm>

¹² *ASEAN Microeconomic Outlook*, 1997-1998.

¹³ Robert Mc Kee, *Why did it Happen?*. Available at [http://www. Megastories.com/seasia/why/why.htm](http://www.Megastories.com/seasia/why/why.htm)

C. CAUSES OF THE FINANCIAL CRISIS

Most ASEAN countries maintained an exchange rate pegged to the US dollar for many years. This provided a sense of security to the business security. However, when the US dollar started to strengthen in 1995 and throughout 1996, particularly vis-à-vis a yen, ASEAN currencies also became stronger. The stronger ASEAN currencies partly explain the decline in exports of ASEAN in 1996, which grew by only about 8 percent compared with 14 percent in 1995. For Thailand, export growth was essentially nil in 1996. The decline in exports could also be partly explained by the loss of ASEAN countries' export competitiveness, particularly in electrical goods, which constituted more than half of ASEAN exports. The decrease in exports worsened the trade deficit, increasing the current account deficit.¹⁴

The rapid economic expansion in the region had increased the demand for foreign borrowing. In an environment of stable exchange rates, the high interest rates in ASEAN countries, foreign capital inflows increased. Statistic from the Bank for International Settlements show that by the end of June 1997, cross-border claims in all currencies and local claims in non-local currencies for eight ASEAN countries (excluding Singapore) reached a total of US\$173 billion. It is interesting to note that about 60 percent of these claims were from the non-bank sector. This was stimulated by the opening of the capital

¹⁴ "Why did Asia Crash?" *The Economist*, June 10, 1998, p. 66.

accounts in ASEAN countries. In Indonesia, Malaysia, and Thailand, the non-bank private shares were as high as 67 percent, 57 percent, and 59 percent, respectively.¹⁵

The increase in the availability of capital enabled the expansion of loans for private spending particularly in real estate and motor cars, creating a price bubble for these sectors. When the bubble collapsed, the entire financial system was severely affected. In Thailand, the Bank of Thailand initially attempted to support financial institutions in difficulty. Its failure to salvage the biggest of the finance company, Finance One, in early 1997, attracted international attention particularly from foreign lenders, triggering fears of loan defaults and worsening creditworthiness.¹⁶ Short-term loan creditors started to withdraw their funds from these institutions.

In addition, expectations of a Japanese recovery in early May 1997 led to sharp appreciation of the yen and a sudden rise in Japanese short-term interest rates. Investors started to withdraw their funds from Southeast Asian markets to take advantage of the higher interest rates in Japan. The withdrawal of short-term credit placed considerable pressure on the reserves and exchange rates, making the baht vulnerable. The bank of Thailand virtually lost all its reserves while attempting to defend the baht, and was forced

¹⁵ Bank of International Settlement, "The Maturity, Sectoral and Nationality Distribution of International Bank Lending First half 1997", *Bank of International Settlement, Monetary and Economic Department*, (Basle, Switzerland, January 1998).

¹⁶ Nayan Chandra, "Rebuilding Asia", p. 46

to float the currency on 2 July 1997. By the end of that month, Thailand had requested assistance from the International Monetary Fund (IMF).¹⁷ By then the contagion effect had spread to the Philippines, Malaysia, and Indonesia, which then floated their exchange rates. At its most basic, the debate over the causes of the crisis centers on whether the cause was first the weakness in the fundamentals of the ASEAN economies or secondly the risk factors associated with open capital and financial markets. However, one cannot discount the fact that different factors played a role at different times and in different countries in the progressive worsening of the crisis. As such, to identify one basic cause of the crisis would be too simplistic.

1. Weaknesses in Macroeconomic Fundamentals

Professor Krugman has argued that there has been no East Asian Miracle and that the high growth rates achieved by the region had come about mainly from the increases in the utilization of the factors of production (labor and capital) rather than from an increase in the productivity of these factors.¹⁸ While the empirical basis of that argument has continued to be debated, a data compiled by the World Economic Forum to measure competitiveness, claims to find evidence of loss of competitiveness among the ASEAN

¹⁷ David E. Sanger and Mark Landler, "Asian Rebound Derail Reform as Many Suffer", *The New York Times*, July 12, 1999, p.A1.

¹⁸ Paul Krugman, "The Myth of Asia Miracle", *Foreign Affairs* 73, no. 6 (November/December 1994), p. 78.

economies.¹⁹ This occurred even as growth had resumed in Latin America and while new low-cost competitors such as China and India had arisen. The result has been the erosion of ASEAN's share in export markets and more competition for scarce foreign direct investment.

A number of important features in the financial systems of the region have been widely cited as contributing to the current crisis. Foremost among analysts' concerns has been poor regulation of financial systems. The rapid expansion of credit and the resultant accumulation of assets of poor quality have been taken as important confirmation of the region's poor regulation of financial institutions.²⁰

The policy of fixing the exchange rate of the local currency to the dollar also aggravated the problem. Interest rates in the ASEAN countries have typically been higher than international rates. With the exchange rate risk absorbed by the central bank, the interest rate differential induced the inflow of both long-term and short-term investments. Domestic companies found it cheaper to borrow from offshore markets rather than from the domestic financial system. As a result, there was an unsustainable accumulation of short-term foreign indebtedness.²¹

Implicit guarantees that some banks or financial institutions were too big to fail also contributed to moral hazard. Financial institutions tended to take more risks than

¹⁹ Tan Kong Yam, "The Regional Economic Crisis: Looking at the Lessons" (Paper presented at eighth Southeast Asia Forum, 14-17 March 1998, Kuala Lumpur Malaysia).

²⁰ Jeffrey Sachs, "Missing Pieces" *Far Eastern Economic Review*, February 25, 1999.

²¹ Bijan B. Aghevli, "The Asian Crisis: Causes and Remedies", *Finance and Development*, June 1999, p. 28.

would have been justified without the guarantee. This was a result of rapid but poorly managed liberalization of the financial sectors in the region.²²

However, it would be unrealistic to focus attention on regional banks alone. Statistics indicate that a large portion of private debt in the region had been channeled directly through foreign banks, particularly in Thailand, Malaysia, and Indonesia. The moral hazard proposition can therefore be extended to the international financial sectors. Perhaps a lack of a clear international legal framework for financial institutions contributed to the over-extension of loans to the private sectors in the region.

While the degree of compliance with international norms of financial reporting varies in the region, there is general feeling that it is less than optimal. Siamwalla has pointed that the accounts kept by many "finance" companies in Thailand that went bankrupt were unreliable.²³ Without reliable and adequate financial accounts in these institutions, it is difficult for regulators to monitor properly the level of risk incurred by these companies. As a consequence of these weaknesses, the financial system in the region was unable to perform its proper functions of allocating savings to those sectors with the highest social returns, and sorting good from bad credit risks.

Problems of cronyism, nepotism, and lack of good governance such as wide practice of using non-transparent process for awarding lucrative commercial deals, usually based on the political or family connections have encouraged lending to

²² Jeffrey Sachs, "Missing Pieces".

²³ Ammar Siamwalla, "The Unfinished Agenda" (Presentation at the Asian Development Forum, 6-9 March 1998, Manila, Philippines).

companies connected to the powers. This was done regardless of the intrinsic viability of those companies and their projects, which wasted a lot of funds. While anecdotal evidence of such practices may be found, it is difficult to gauge their true extent in the region. Even more important, it is difficult to determine whether the economic consequences of these practices differ significantly from the pork-barrel politics practiced in other parts of the world. In countries which lack appropriate market and legal institutions within which adequate information can be obtain and legal contracts can be properly enforced, implicit and informal arrangements may be an efficient, albeit transitional, means for regulating economic activity.²⁴

2. Openness of the Capital Account

The other explanation stresses the inherent risks associated with financial markets and liberalization. According to this explanation, moral hazard, bubbles, and the herd instinct are natural features of financial markets. Hence, under some circumstances, it is possible to turn a local instability into a global one. Stiglitz has linked the ASEAN financial turmoil to a small boat out in the open sea. One can make the boat as seaworthy as possible but in the end, a huge storm can tip the boat over, no matter how well it was made. In his view, financial market is intrinsically different from markets for commodities. In the market for grain, the price of corn quoted on the Chicago Board of Trade tells the buyer and seller all that they need to know about the product. As the price

²⁴ Dan Biers and Charles S. Lee et. al. "Resuscitating Asia", *Far Eastern Economic Review*, June 18, 1998, p. 10.

goes up, quantities demanded and supplied move in predictable directions. On the other hand, the price of financial contract does not contain all the necessary information needed by the buyer and seller. This market is characterized by information asymmetries and hence the price may be misleading indicator of the quality of the financial product. Hence it is possible that as the interest rate that a borrower is willing to pay increases, the lender may be justified in actually turning away the borrower since it may indicate the underlying riskiness of the borrower. Furthermore, financial markets are subject to bubbles and to self-fulfilling prophecies. The massive short-term private capital inflows into developing countries have long been studied, and economists have warned of the consequences. Given the "openness" of the international financial markets would be unjustifiably damaging.²⁵

McKinnon and Pill have described how the opening up of the capital account can aggravate inherent problems of moral hazard on the part of domestic financial institutions. Opening up the capital accounts lead to overgrowing by the domestic financial system, which exacerbates the eventual crisis.²⁶

The associated pitfalls with the opening up the capital account are not mere theoretical constructs. Previous episodes have occurred in Chile in 1981 and Mexico in 1995. In fact, Chile's experience led it subsequently to apply direct controls on foreign

²⁵ Joseph Stiglitz, "The Unfinished Agenda" (Presentation at the Asian Development Forum, 6-9 March 1998, Manila, Philippines).

²⁶ R. Mc Kinnon and Pill Huw, "Credible Economic Liberalizations and Overborrowing", *American Economic Review* 87, no. 2 (May 1997), p. 193.

capital flows, although it has long been held as a paragon of laissez faire policies. In the case of ASEAN turmoil, Montes has argued that in Thailand and Indonesia, the openness of the capital control account led to an increase in foreign borrowing by financial institution, especially the commercial banks.²⁷

The inflows of short-term funds can quickly create an asset bubble. Then, it is only a matter of time before animal spirits, or exuberance, led to bad investment choices. Once foreign capital inflows accumulated in the domestic financial system, small perturbations or shocks can quickly led to a massive withdrawal of finance with a consequent deflation of asset prices, loss of investor confidence, increasing domestic bankruptcies and a decrease in real activities.²⁸

The region did see a massive run-up in stock market and real estate values in the 1994-96 period at the height of market mania. While good and poor investment choices were certainly made, the overall quality of investments made with the funds would have declined. Then a flurry of bad news such as the export slow-down in the region began to affect investor confidence. This precipitated speculative attacks against regional currencies, and once the baht was devalued the process quickly unraveled.

Clearly, a sober response to the financial crisis must require policy makers to consider all possible explanations of the crisis and not prematurely discount one explanation or the other. Each of these explanations must be weighed carefully for they

²⁷ M. S. Montes, *The Currency Crisis in Southeast Asia* (Updated Edition) (Singapore: Institution of Southeast Asian Studies, 1998).

²⁸ Jeffrey Sachs, "Glimmers of Hope", *Far Eastern Economic Review*, November 5, 1998, p. 53.

are likely to contain the truth that would help the region ultimately break free of the consequences of the turmoil.

D. IMPACT OF THE CRISIS

The financial crisis has had a significant impact on ASEAN countries, the effects of which are likely to be felt beyond the immediate and medium terms. Chronologically, what started out as an exchange rate crisis swiftly became a banking and financial crisis. By late 1997 it had infected the real sectors due to the rising interest rates, higher costs of import, credit crunches in the banking sector, and the resultant bankruptcies of firms which had become insolvent.²⁹

The financial crisis has directly affected four ASEAN countries: Thailand, Malaysia, Indonesia, and Philippines. Panic in the financial markets caused the exchange rates for these countries to weaken and destabilize. The depreciation of these currencies placed pressure on Singapore, the regional trade center, to follow suit. Brunei earns petrodollars from its exports of oil and gas, and major imports of food come from ASEAN countries with devalued currencies; but Brunei dollar was also devalued since it is tied to the Singapore dollar. The new members of ASEAN, Vietnam, Laos, and Myanmar, and future member, Cambodia were also affected, as most of their foreign direct investments come from the older member countries of ASEAN.³⁰

²⁹ Dan Biers and Charles S. Lee et. al. "Resuscitating Asia", p. 10.

³⁰ David E. Sanger and Mark Landler, "Asia Rebound Derail Reform as Many Suffer".

1. Weaker, Unstable Exchange Rates and Weakened Financial Institutions

The impact was first felt in the foreign exchange markets, with ASEAN currencies being devalued in a dramatic fashion, and within a very short period of time. At it worst during the first week of January 1998, the baht had fallen by forty percent, the rupiah by eighty percent, the ringgit by forty percent and the peso by thirty percent against the dollar from their values on July 1, 1997.

Because of the high exposure of the domestic banking and financial systems in the unhedged foreign debts, the fall of local currencies immediately bloated the liabilities of these institutions, rendering many of them technically insolvent. As a result Indonesia was forced to close sixteen banks while Thailand suspended the operations of fifty-six finance companies, then eventually closed fifty-four.³¹

2. Higher Interest Rates

To moderate the continuing pressure on the local currency, policy-makers across the region had to raise domestic interest rates. This made the situation worse for the financial institutions, since the cost of funds rose even as they struggled with their foreign exchange liabilities. The higher interest rates made it difficult for companies to obtain funds for investment, for working capital, and in some cases, even trade financing. The high interest rate regime led to a slow-down in manufacturing and industrial activity in

³¹ Jeffrey Sachs, "Missing Pieces".

the region. The difficulties were compounded by the higher cost of imported raw materials because of the depreciation as well as the credit crunch on banks to give out loans to companies. As a result many companies have had to shelve expansion plans, bring down inventory levels, and lay off workers.³²

3. Unemployment

Although there is no thorough study on the level of unemployment generated by the financial crisis, recent statistics on the closure of business operations show that it will be quite large. Since the financial crisis started in July 1997, over 430 companies in the Philippines have close down and about 40,000 workers laid off. The closure of these companies will in turn lead to a subsequent round of consolidation in employment in all companies. The International Labor Organization has estimated an increase in unemployment of 3 million in Indonesia, 1.5 million in Thailand, and about 150,000 in Malaysia.³³

4. Social Impact

One of the worrying aspects of the crisis is the prospect of long-term damage to the economic and social fabric of the region. In most ASEAN countries essential medical product are imported. The devaluation will increase the costs of health care. At the same

³² Bijan B. Agheveli, "The Asian Crisis: Causes and Remedies".

³³ Celito Habito, "The East Asian Crisis: Social and Environmental Impacts" (Keynote Address at the Conference of East Asia: The Unfinished Agenda, organized by Asian Development Forum, 6-9 March 1998, Manila, Philippines).

time the reduction of government budgets will eat into public health care programs. Such factors, together with the decrease in household incomes, will undoubtedly reduce health care, especially the poor.

One of the tragic coincidences of the financial crisis is that it occurred at a time when some countries in the region were going through their worst drought in decades as a result of the El Nino phenomenon. The currency devaluation aggravated this by increasing the domestic price of all tradable commodities, including food. For the urban poor, this increase in the price of food will have an impact on the quality and quantity of nutrition. In the case of Indonesia and some areas in other ASEAN countries, the rural poor will not have that luxury due to the devastating effect of the Al Nino. In some cases, children will have to leave school because on the increased cost of schooling and the need for them to work to contribute to the income of the family. This will have a long-term impact on the quality of the labor force in the region.

The crisis may also lead to a deterioration of the environment in the region. As government cut spending to maintain fiscal balance, environmental protection may rank low in priority. The decrease in household incomes may also force the poor to exploit natural resources more intensively, leading to problems such as over-grazing and over-fishing. Such increase in the use of natural resources may, in turn, affect the sustainability of the environment.

5. Regional and Global Economies

The financial crisis will have significant international repercussions. The ASEAN countries collectively represent the fourth largest trading region in the world market. In 1996, ASEAN exported about \$650 billion and imported approximately \$700 billion.³⁴ Since the exchange rates of most currencies in ASEAN have been reduced at similar rates, there has been limited change in the cross exchange rates among these countries. This may not induce much change in the pattern of intra-regional trade. Imports from ASEAN countries may have become relatively cheaper while exports to non-ASEAN countries may be more attractive, resulting in an increase in the trade imbalance regionally among ASEAN countries. However, the increase in imports may be checked by the decrease in incomes in each country in the region.

The change in exchange rates particularly vis-à-vis major trading partners, such as United States, the European Union, and Japan will reduce extra-regional imports and increase extra-regional exports. The decrease in exchange rates will make ASEAN exports cheaper internationally. Increasing exports is key to recovery in ASEAN. This requires the market for major export destinations to remain open. ASEAN imports will diminish because of the reduction in purchasing power brought about by the depreciation of currencies and the reduction of income. An increase in the trade surplus is expected. The resultant increased competitiveness of ASEAN products in export markets, and the

³⁴ Rober R. Teh Jr., "Green Shoots of Recovery".

reduction in imports by ASEAN countries, would induce a reduction in global economic growth.

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III. THE FINANCIAL CRISIS IN MALAYSIA

A. INTRODUCTION

During the period preceding the crisis, East Asian economies including Malaysia experienced several years of rapid economic growth. This growth was accompanied by low rates of inflation, rising per capita income and reduction in the incidence of poverty. During 1987-96 the Malaysian economy grew at an average annual rate of 8.8 percent, lifting per capita income from US\$ 1,850 to US\$4,425. The economy was at virtual full employment for the last six years, with modest inflation at 4.5 percent.³⁵

The financial crisis was triggered by the speculative attack on the Thai baht amidst concerns of a slowdown in exports, significant overvaluation of the currency, high short-term external debt and the decline in asset prices in Thailand. This caused anxiety among investors and many believed that similar risks were present in the other regional economies. This led to the deterioration in market sentiments and the general erosion in investor confidence which in turn, sparked off the massive outflow of short-term capital and a series of reductions in the value of regional currencies and stock markets. The attack on the Thai baht was immediately followed by similar attacks on the Philippines peso and the Indonesian rupiah. Subsequently, the ringgit as well as the Singapore dollar

³⁵ Prema-chandra Athukorala, "Swimming Against the Tide: Crisis Management in Malaysia", *ASEAN Economic Bulletin*, Dec 1998.

came under selling pressure followed by the Korean won and Taiwan dollar. Essentially, investors perceived all the East Asian economies as identical and facing similar problems of the same magnitude. They were unwilling to differentiate among individual East Asian economies.

B. FUNDAMENTAL STRENGTHS OF THE MALAYSIAN ECONOMY

There are many favorable features of the Malaysian economy prior to the crisis in 1997. During the five years leading up to 1996, its real GDP growth averaged 8.7 percent per annum, inflation was low around 3.8 percent, and the unemployment rate for 1996 was only 2.6 percent. Unlike some other East Asian Economies with high external debts, Malaysia has relatively lower external debt of US\$45.2 billion or 42 percent of GDP as at June 1997. The debt service ratio was only 6.1 percent of export as at end 1996. The banking sector was healthy, with non-performing loans (NPLs) at only 3.6 percent of total loans as at June 1997. The nation's saving rate at 38.5 percent in 1996 is one of the highest in the world.³⁶

Although aggregate or macro numbers can sometime mask some inefficiency in the case of neighboring countries, this was less so for the Malaysian economy. However, the nervousness of the market over some issues in countries such as Thailand, Indonesia and South Korea led to the contagion effect that brought the economic crisis to Malaysia and resulted in gross undervaluation of the exchange rate. Tables 1 and 2 highlight the

³⁶ National Economic Action Council, *National Economic Recovery Plan: The Crisis and Policy Response*, Kuala Lumpur, 1998.

performance of some of the main economic indicators, while Table 3 provides some international comparisons.

Table1: Economic Performance Indicators, 1993-1998

	1993	1994	1995	1996	1997	1998
Population (million persons)	19.6	20.1	20.7	21.2	21.7	22.2
Labor force (thousand persons)	7,627	7,834	8,257	8,641	9,038	8,881
Employment (thousand persons)	7,498	7,603	8,024	8,417	8,805	8,538
Unemployment (%)	3.0	2.9	2.8	2.6	2.6	3.9
Per capita income (RM at current prices)	8,024	8,996	10,068	11,228	12,051	11,835
Gross national savings (RM million at current prices)	54,534	62,133	73,448	91,572	102,807	108,075
% of GNP	34.7	34.4	35.3	38.5	39.4	41.2
Gross Domestic Product (RM million at current prices)	165,206	190,274	218,671	249,503	275,367	278,724
Gross Domestic Product (RM million at 1978 prices)	100,617	109,976	120,272	130,621	140,684	131,258
Growth Rate (%)						
Gross Domestic Product	8.3	9.3	9.4	8.6	7.7	-6.7
Agriculture, forestry and fishing	4.3	-1.0	1.1	2.2	1.3	-4.0
Manufacturing	12.9	14.7	14.2	12.3	12.5	-10.2
Mining and quarrying	-0.5	2.5	9.0	4.5	1.0	0.8
Construction	11.2	14.1	17.3	14.2	9.5	-24.5
Services	9.8	9.7	9.4	9.7	8.0	1.5
Gross National Product (RM million at current prices)	156,941	180,862	208,294	237,687	261,094	262,494
Gross National Product (RM million at 1978 prices)	95,291	104,006	113,704	123,166	132,811	124,476
Growth Rate (%)						
Gross National Product	8.7	9.1	9.3	8.3	7.8	-6.3
Public consumption	10.7	9.9	7.3	1.4	5.3	-3.5
Private consumption	4.6	9.9	9.3	6.0	4.7	-12.4
Public investment	8.4	-0.6	8.7	1.1	8.6	-10.0
Private investment	19.1	27.9	25.3	13.4	8.4	-57.8

Exports	17.2	22.5	17.6	7.2	10.8	-0.7
Imports	19.1	27.7	21.4	4.2	10.2	-18.3
Balance of Payments (RM million)						
Merchandise balance	8,231	4,460	97	10,154	11,337	69,322
Services balance	-16,670	-17,005	-19,229	-19,414	-21,792	-23,381
Transfers	513	-2,225	-2,515	-2,936	-3,698	-9,873
Current Account	-7,926	-14,770	-21,647	-12,196	-14,153	36,068
% of GNP	-5.1	-8.2	-10.4	-5.1	-5.4	13.7
External Trade (RM million)						
Total exports (f.o.b.)	121,238	153,921	184,987	197,026	220,890	286,756
Total imports (c.i.f.)	117,405	155,921	194,345	197,280	220,936	228,309
Balance of trade	3,833	-2,000	-9,358	-254	-45	58,446
Consumer Price Index (%)	3.6	3.7	3.4	3.5	2.7	5.3
External debt (RM million) ¹	69,181	76,062	85,014	98,086	170,757	159,775
Debt service ratio (% of exports)	7.1	5.5	6.6	6.9	5.5	6.7
% of GNP	44.1	42.1	40.8	41.3	65.4	60.9
Net Bank Negara Reserves (RM million)	76,435	68,173	63,770	70,015	59,123	99,424 ²
Months of retained imports	7.8	5.5	4.1	4.4	3.4	5.7

Source: Department of Statistics and Bank Negara Malaysia

Some of the fundamental strengths of the Malaysian economy at the onset of the crisis were:

i) **Low Inflation.** Price pressures were absent. The inflation rate measured in terms of the consumer price index (CPI) was low. For the period January-July 1997, the CPI averaged 2.7 percent, comparable with many developed economies.

Table2: Public Sector Performances, 1993-1998

	1993	1994	1995	1996	1997	1998
Federal Government Finance (RM million)						
Revenue	41,691	49,446	50,954	58,280	65,736	56,710
Operating Expenditure	32,217	35,064	36,573	43,865	44,665	44,584
Current Account Balance	9,474	14,382	14,381	14,415	21,071	12,126
Development Expenditure	9,120	9,974	12,520	12,600	14,445	17,128
Overall Balance	354	4,408	1,860	1,815	6,626	-5,002
% of GNP	0.2	2.4	0.9	0.8	2.5	-1.9
Public Sector Finance (RM million)						
Revenue	52,612	61,136	62,271	70,912	81,528	71,392
Operating Expenditure	37,659	40,452	41,394	50,463	51,884	51,894
Current Account Balance	14,953	20,594	20,877	20,449	29,644	19,496
Non-financial public Enterprises' Surplus	13,643	18,403	15,993	20,348	27,680	23,046
Total Public Sector Current Balance	28,596	35,397	36,870	40,797	57,324	42,542
Development Expenditure	32,307	28,753	29,801	30,818	39,992	47,219
Overall Balance	-3,711	6,644	7,069	9,979	17,332	-4,677
% of GNP	-2.4	3.7	3.4	4.2	6.6	-1.8

Source: Statistics Department, Ministry of Finance and Bank Negara Malaysia

ii) **Full Employment.** The rate of unemployment was 2.6 percent in 1997, which is considered a full employment level. In comparison, the unemployment rate in the Organization of Economic Cooperation and Development (OECD) countries was 7.5 percent.

iii) **High Savings.** The national savings rate stood at 39.4 percent of Gross National Product (GNP) in 1997 which was among the highest in the world.

Table3: International Comparison of Economic Indicators, 1997-1999

	1997	1998	1999
Growth of Real GDP (%)			
Malaysia	7.7	-6.7	1
Indonesia	4.9	-13.7	-4
Philippines	5.2	-0.5	2.5
Singapore	8	1.5	-1
Thailand	-0.4	-8	1
South Korea	5.5	-5.4	3.2
China	8.8	7.8	7
Hong Kong	5.3	-5.1	0.5
Taiwan	6.8	4.8	4.7
Industrial countries	3.1	2.3	2
United States	3.9	3.9	2.8
Japan	1.4	-2.9	-1.2
United Kingdom	3.5	2.5	0.9
Inflation (%)			
Malaysia	2.7	5.3	4
Indonesia	10.3	77.6	12
Philippines	6	9.7	8
Singapore	2	-0.3	-1
Thailand	5.6	8.1	3
South Korea	4.5	7.5	3
China	0.8	-2.6	2
Hong Kong	5.7	2.6	-2
Taiwan	0.9	1.7	1.6
Industrial countries	2	1.4	1.4
United States	2.3	1.6	1.8
Japan	1.7	7	0
United Kingdom	2.8	2.6	2.5
Current Account Balance (% of GDP)			
Malaysia	-5.1	12.9	10.4
Indonesia	-2.3	4.4	2.5
Philippines	-5.3	1.1	0.6
Singapore	15.8	20.9	...
Thailand	-2	12.3	8.5
South Korea	-1.9	...	7
China	3.3	2.4	1.8
Hong Kong	-3.5
Taiwan	2.7	1.3	...
Industrial countries	1.5	1.2	1
United States	-1.9	-2.7	-3.3
Japan	2.2	3.4	3.3
United Kingdom	0.6	-0.5	-0.7

Source: World Economic Outlook, IMF, December 1998

iv) **Low External Debt.** Malaysia's exposure to external debt was comparatively low at RM115.1 billion or 44.1 percent of GNP at the end of June 1997, mostly long-term in nature and its debt commitments were prudently spaced out. In addition, the debt service ratio was at a manageable level of 5.5 percent. The currency composition of liabilities also corresponded fairly closely with the currency composition of earnings, providing a natural hedge against currency risks.

v) **Healthy External Reserves.** International reserves held at BNM as at June 1997, amounted to US\$27.4 billion which was sufficient to finance approximately 4.3 months of retained imports, a level considered satisfactory by international standards. The reserves were free of any form of encumbrances and forward commitments.

vi) **Declining Current Account Deficit in the Balance of Payments.** Although Malaysia recorded a persistent deficit in its current account of the balance of payments, which peaked in 1995, concerted measures introduced by the Government in this respect led to its subsequent improvement. The deficit amounted to RM21.6 billion or 10.4 percent of GNP in 1995, but declined to RM12.2 billion in 1996 and RM14.2 billion in 1997, equivalent to 5.4 percent of GNP. Furthermore, Malaysia was able to finance this deficit through its long-term capital flows entirely of foreign direct investment (FDI), without having to rely on short-term capital, thus reducing its vulnerability to external shocks.

vii) **Strong Fiscal Position of the Government.** The overall public sector account was in surplus since 1994. In 1997, the overall surplus of the public sector amounted to RM17.3 billion or equivalent to 6.6 percent of GNP, reflecting the higher

revenue base as well as prudent fiscal management (table 2). Federal Government's external debt stood at RM9.1 billion at the end of June 1997, while its external debt service ratio was 0.9 percent.

viii) Predictability and Consistency of Government Policies. The predictability and consistency of Government policies provided certainty to the private sector. It gave confidence to both domestic and foreign investors to commit to long-term investments in the country and considerably reduced risks.

ix. Political Stability. The continued governance of the nation by the same coalition of political parties since independence contributed to political stability and inter-racial harmony. In each of the election held from 1974 to 1994, the National Front received between 53 and 61 percent of the vote cast, yet the proportion of seats in the lower house to which these results entitled the Front almost never fell below 80 percent.³⁷ Regular, free and fair elections ensured the legitimacy of the political system. The continuing political stability facilitated the implementation of pragmatic policies and enabled the uninterrupted development of the nation. The political stability was also fundamental to ensuring a business-friendly environment and in attracting foreign investment.

x) Low Incidence of Poverty and Increasing Size of the Middle Class. The low incidence of poverty and the increasing size of the middle class contributed directly to economic growth in terms of their enhanced capacity to spend as well as

³⁷ Harold Crouch, "Malaysia", in R.H. Taylor, ed., *The Political Election in South East Asia* (Washington D.C.: Woodrow Wilson Centre, 1996), p. 119.

invest. The increasing size of the middle class also avails a large pool of professionals and skilled manpower to support sustained economic growth.

C. EMERGING CONCERNS

The Government, however, was aware of some emerging concerns in the domestic economy and thus, put in place measures to address them. These vulnerabilities were perceived as a build-up of risks in the economy, which subsequently affected investor confidence. Since 1991, the economy consistently grew above its potential output. This has caused the economic growth above the potential output. Zero output gaps is when actual and potential GDP are equal in size. The output gap increased during 1994-96, as actual GDP grew faster than potential GDP.³⁸ This has generated price pressures, especially in the form of wage increases above productivity gains. Instead of improvements to efficiency growth during this period was primarily brought about through augmenting input, a situation that is not clearly sustainable in the longer term. It is greater cause of concern when a significant proportion of these inputs (both capital and labor) was imported. This was reflected by investment persistently exceeding savings, increasing demand for foreign labor, widening current account deficit of the balance of payments and wage increases exceeding productivity gains.

The efficiency in the utilization of resources in the economy is indicated by estimates of Total Factor Productivity and the incremental capital output ratio. There is a

³⁸ National Economic Action Council, *National Economic Recovery Plan: The Crisis and Policy Response*, Kuala Lumpur, 1998.

loss of efficiency in the economy. During 1995-97, the investment rate had been around 46 percent of GDP. The steeply rising in incremental capital-output ratio for the last three years, indicate that the use of capital had been increasingly less efficient. The Efficiency level, measured in terms of total factor productivity (TFP), was on a downtrend. Its contribution to real GDP growth declined from 28.7 percent during 1991-1995 to 19.5 percent during 1996-1997.³⁹ The decline is associated with the transition of the economy to high technology and knowledge-based industries, which in the initial stage requires rapid capital accumulation. Further, measures which have been put in place are expected to be translated into productivity improvements only in the medium term.

The deficit in the current account corresponds to the saving-investment gap. Despite having the highest saving rate in the world, Malaysia ran into current account deficit problems because of its high investment rate. The investment boom led to the current account deficit, and when coupled with the declining efficiency in capital utilization, is a legitimate cause of concern. The current account deficit was only partially financed by net long-term capital inflows for some of the years. At the same time, reverse investments have steadily increased from RM 4 billion in 1993 to RM 11.4 billion in 1996, an increase of 2.8 times. Malaysian investment overseas in 1997 was estimated at RM 9.9 billion.

Since 1995, total loans had been growing at a rapid pace. The monthly total loan growth was around 28-30 percent in 1997, except for November and December. This has

³⁹ Ibid.

created an excessive credit expansion to the non-tradable sectors. For most of 1997, loans to the property sector were growing above 30 percent and amounted to 26 percent of total loans. Loans of the purchase of stock shares during 1993-97 grew at an average rate of 35 percent per year. Following the rapid expansion of credit, private domestic debt escalated in the past few years.⁴⁰

Malaysia's impressive decade long growth record came to an abrupt halt with the depreciation of the ringgit, which occurred within two weeks after the floatation of the Thailand baht on July 2 1997. The fall of the Thai Baht raised concerns about the resilience of the exchange rate arrangements in the region. Buoyed by the success and profit associated with the floatation of the baht, currency speculators next focussed their attention to the other regional currencies with renewed vigor. The Philippine peso was floated on July 11, while Indonesia allowed the rupiah to fall sharply within the official intervention band on July 21.

Initially, Malaysia tried to defend the Ringgit when it came under attack, but this strategy was not sustainable and proved costly. The central bank, Bank Negara Malaysia (BNM), responded with massive foreign exchange market intervention; it sold close to US\$1.5 billion to prop up the ringgit. It held the ringgit firmly through continued market intervention for another week and then gave way to market forces on July 14 by floating.⁴¹

⁴⁰ Ibid.

⁴¹ Prema-chandra Athukorala, "Swimming against the Tide: Crisis Management in Malaysia".

On July 14, the ringgit was allowed to depreciate. From RM 2.50 to US\$1, the ringgit slipped to US\$2.61 (July 14) and gradually to RM 2.72 (August 11) and RM 2.83 (August 12), before reaching RM 3.00 on September 2. The ringgit sank to the lowest of RM 4.88 on January 7, 1998, before recovering along with the regional stock market rally after the Chinese New Year holidays. Between the first week of July 1997 and January 7, 1998 when the slide hit bottom (RM 4.88 = US\$ 1), the ringgit depreciated against the dollar by almost 50 percent. After showing some signs of stability during February and March, the exchange rate continued to deteriorate with wide swings in the following months until it was fixed at the rate of RM 3.80 to US\$ 1. This contrasted with the experience of Thailand and Korea where from March onwards their currencies showed signs of stabilizing at higher levels.⁴²

The turbulence at the Kuala Lumpur Stock Exchange (KLSE) was closely tied to the ringgit depreciation. Although the KLSE started declining in the early part of 1997, the fall grew in earnest after Thailand announced the floatation of the baht. In order to prevent the currency speculation, in early August 1997 Bank Negara (Central Bank) imposed US\$ 2 million limit on outstanding non-commercial related ringgit offer-side swap transaction with any single foreign customer. This was later followed by KLSE declaring the 100 component stocks of the KLCI as designated securities. The short selling in the stock market was suspended through the prohibition of securities borrowing

⁴² Ibid.

and lending. Local funds were encouraged to start buying shares at the time when foreign funds were retreating. The series of measures adopted in August failed to stop market panic. From the high of 1271 level in February 25, 1997, the KLSE composite index plunged to 477 points on January 12, 1998, with a loss of about 800 points or 63 percent. At the high of 1997, the market capitalization was RM 917 billion but sank to RM 308.69 billion by January 12, 1998. The KLSE composite index recovered briefly and rose to 745.12 on March 2, 1998. Since April 2, 1998, the KLSE started falling again with reports of poor corporate performance as well as the depreciation of the yen in mid May. The KLSE composite index was 467.55 on July 7, 1998.⁴³

D. ISSUES ARISING FROM THE CRISIS

The financial crisis has had wide-ranging effects. The crisis, which started in Thailand, spread very quickly to the other regional economies due to its highly contagious nature. It adversely affected the real economy of Malaysia, weakened the financial sector and had some socio-economic implications. However, the strong fundamentals allowed Malaysia to avoid the potentially extreme effects of the crisis as experienced in other regional economies. The rate of unemployment, incidence of poverty and the number of bankruptcies remained relatively low.

Some of the main issues arising from the crisis are:

⁴³ National Economic Action Council, *National Economic Recovery Plan: The Crisis and Policy Response*, Kuala Lumpur, 1998.

i) **Contraction of the Economy.** Economic growth measured in terms of real GDP contracted. The impact of the financial crisis on economic growth became evident towards the end of 1997 when the real GDP began to slow down and registered a negative growth beginning the first quarter of 1998, as shown in Table 4. For 1998, real GDP registered a negative growth for the first time since 1985. As a result of the contraction in economic growth, per capita income declined by 1.8 percent to RM11, 835 in 1998 compared with RM12, 051 in 1997 (Table 1).

Table 4: Gross Domestic Product by Quarter, 1995-1998

	Growth Rate (%)			
	1995	1996	1997	1998
First Quarter	10.1	6.8	9.2	-2.8
Second Quarter	10.7	7.6	8.4	-6.8
Third Quarter	9.3	8.8	7.5	-9
Fourth Quarter	7.5	11	6	-8.1

Source: Department of Statistics, Ministry of Finance Malaysia

ii) **Increased Unemployment.** The contraction in GDP resulted in slower employment growth, and increased unemployment as well as retrenchment. However, the unemployment rate did not reach an alarming level, as there were many industries facing labor shortages and capable of absorbing many of these retrenched workers. Employment declined in 1998 by 3.0 percent compared with a positive growth of 4.9 and 4.6 percent in 1996 and 1997, respectively (Table 1). The unemployment rate, however, increased from 2.6 percent in 1997 to 3.9 percent in 1998.

iii) **Price Pressures.** Price pressures arising mainly from the depreciation of the ringgit became apparent towards the end of 1997. The general price level, measured in terms of the CPI, was at an average of 3.5 percent from 1993 –96 but increased to 5.3 percent 1998 (Table 1). Subsequently, price pressures began to ease. Food prices registered the largest price increase. The Producer Price Index (PPI), which measures the average rate of change in prices by domestic producers of commodities and those paid by Malaysian importers, also rose sharply.

iv) **Declining Private Investment.** Private investment has generally contracted mainly due to uncertainties arising from volatile exchange rates, decline in both local and external demand, the existence of excess capacity and tight liquidity position encountered since the onset of the financial crisis in July 1997.

v) **Instability in the Exchange Rate.** The exchange rate of the ringgit vis-a-vis major currencies declined. The ringgit depreciated by 35 percent against USD between 1 July 1997 and 31 December 1997. It was at its lowest level on 7 January 1998.

vi) **Decline in Stock Prices.** The Kuala Lumpur Stock Exchange Composite Index (KLSE CI) declined by 63 percent during the period 1 July 1997 to 31 December 1997. After a slight recovery in the first quarter of 1998, the index slid to an 11-year low of 467.55 points on 7 July 1998 with market capitalization fell by about 66 percent to RM308.69 billion from RM917 billion. Movements of stock prices on the KLSE were affected by several factors, including exchange rate fluctuations, developments in the regional economies and sharp loss of confidence in emerging markets by international investors.

vii) **Socio-economic Implications.** The incidence of poverty among Malaysians decreased from 8.9 percent in 1995 to 6.1 percent in 1997. However, efforts to sustain this rate of reduction were affected in 1998 due to the economic downturn. As the economy contracted, there were limited employment and income-earning opportunities. Coupled with the increase in inflation rate, the incidence of poverty increased to 7.0 percent in 1998.⁴⁴

Further, the drastic decline in share prices and value of property had a negative wealth effect and severely affected the consumption pattern of Malaysians. The poor performance of the KLSE also seriously constrained the ability of the corporate sector to procure financing through the stock market. The fall in the price of shares and property also adversely affected the value of collateral provided by businesses for the loans they had procured. The increase in interest rates following the crisis brought further hardship to the public at large as well as businesses in terms of higher debt service commitments. For instance, a family having to service a housing loan or an overdraft of RM100,000 had to pay about 20 percent more in terms of monthly repayments.

The currency depreciation affected the capacity to pursue education abroad. Institutions offering financial assistance for education abroad, including the Government either stopped or reduced drastically. In this regard, Bumiputera (Malay) students, in particular, have been affected, as most of them were dependent on Government

⁴⁴ Frank Ching, *The Asian Economic Crisis: Social Impact of the Regional Crisis*. Available at http://www.asiasociety.org/publications/update_crisis_ching.html

assistance. Generally, as the cost of education abroad increased sharply, more students had to pursue their education locally.⁴⁵

E. EFFECTS OF THE CRISIS

Currency movements have varying implications on competitiveness and external trade, debt, and investment. Because of ringgit depreciation, Malaysia competitiveness has been enhanced after taking into account the combination of the currencies of Malaysia's trading partners and correcting for inflation among the countries. Malaysian goods are relatively cheaper and more competitive than its trading partners. The effects of the crisis are as follows:⁴⁶

Trade Balance. The currency depreciation will generally help to improve the balance in the current account. With cheaper ringgit, export grow faster than imports, which to reduce the size of the current account deficit. For importers, an exchange rate of RM 4.00 to US\$ 1 means that they now has to pay about 37.5 percent more compared to pre-July 1997 when the exchange rate was at RM 2.50. On the part of exporters, the depreciation of the ringgit has given an export boost to Malaysian products. When compared with the previous year, the value of export in 1997 grew by 12.4 percent in ringgit terms, but only 0.5 percent in USD terms. Compared with the corresponding

⁴⁵ Ibid.

⁴⁶ National Economic Action Council, *National Economic Recovery Plan: The Crisis and Policy Response*, Kuala Lumpur, 1998.

period in 1997, export growth for April 1998 grew by 44.5 percent in ringgit terms. In 1997, imports grew by 12 percent in ringgit terms and 0.2 percent in USD terms.

Manufacturing Exports. The export from the manufacturing sector are largely from non-resource based industries and contribute 80 percent of total exports. The feedback from the private sector suggests that there are limits to the beneficial effect of a devalued currency on manufactured exports. Many firms are already operating in full capacity and cannot increase export quickly to take advantage of the depreciation ringgit. Typically, there is a time lag before the beneficial effects of the currency depreciation trickle down to the real economy. In addition, importers overseas are pressing Malaysian exporters for discounts so that the value of export is reduced. The cost of imports, which go into manufactured exports, has also increased substantially, and this can result in subdued improvement in the current account.

Primary Commodities. In term of primary commodities, there was a little effect on the ringgit depreciation on rubber prices since they are quoted in ringgit. Rubber prices rose slightly from RM 279.3 per kg. in June 1997 to RM 287.3 in April 1998 due to exporters adjusting the upwards since this increment would be negligible in US dollar terms. On the other hand, palm oil price is quoted in US dollars had risen significantly from RM 1215 per tonne in June 1997 to RM 2366 per tonne with strong world demand for vegetable oils and the export ban on palm oil by Indonesia since January 1998. The prices of log and sawn timber are on the downward trend due to falling demand in Japan and the continued anti-tropical wood sentiment in Europe.

The ringgit depreciation has varying effect on rubber products. Dry rubber-based industries, such as rubber tires and footwear, have been adversely affected because they have high import content and oriented to the domestic market. However, latex-based products, such as gloves, condoms and catheters, that used local materials and sold in US dollars have benefited. The furniture industry is enjoying high profits because the export prices are quoted in US dollars and 80 percent of the materials are obtained from local sources.

Imported Inputs. The sectors heavily dependent on imported machinery and materials are worst hit by currency depreciation. The civil engineering subsector, which uses the imported materials and heavy machinery equipment priced in US dollars for infrastructure development, is burdened by higher cost of repayment and interest of over 50 percent with the depreciation of the ringgit. In the case of cement production, the higher cost of imported inputs, such as coal, gypsum, and other raw materials, will increase production costs by RM 180 million based on the exchange rate of RM 4.00 to US\$1.

There are also other impacts of worsening exchange rates. The depreciated ringgit has caused an increased in the domestic prices as a result of rising costs of imported intermediate goods. The rising consumer prices will also caused real household income and real wages to fall. There will be a proportionate increase in the value of external debt exposure for foreign debt dominated in foreign currencies. At the end of April 1998, Federal Government external debts amounted to RM11.3 billion. However, if the same amount of debt calculated on the basis of exchange rate before the depreciation in mid

1997, they would amount to Rm8.6 billion. In other words, the ringgit depreciation increases the Federal Government foreign debt repayment by RM2.7 billion or 31.4 percent. The depreciation of ringgit will also caused deceleration in the growth of domestic private investment. This is due to uncertainties in the exchange rate, low business confidence, and credit crunch. If the exchange rate continue to remain unstable, the economic growth rate will also be affected and deteriorated.

Early into the crisis, the government adopted adjustment policies. A series of policy measures were adopted to deal with the financial crisis and stabilized the economy. The 1998 budget and the 5 December package of policies contained measures to reduce current account deficit, strengthen balance of payments and fiscal account, improve competitiveness, and increase monetary and financial stability. The 1998 budget announced in 17 October 1997 encompassed the following measures:

i) Reduce the Federal Government expenditure by 2 percent, deferment of mega projects, and review of public agencies' purchases of foreign goods.

ii) On the financial aspect, the prudential standards were strengthened with the classification of non-performing loans in arrears from six to three months, greater financial disclosure by banking institutions, and increasing general provision to 1.5 percent.

iii) The Credit Plan was introduced to limit overall credit growth to 25 percent by the end of 1997, and 15 percent by the end of 1998. In providing loans, banking institutions were to give priority to productive and export-oriented activities.

On 5 December 1997, the Government announced an additional package of policies when the regional instability proved to be more protracted than earlier anticipated. These policy measures were aimed at strengthening economic stability and instilling confidence in the financial system. There were concerns about the large current account deficit and high private sector debt amounting to 169 percent of GDP in 1997. Hence, there was a need to prudently managed public sector finances while curbing excesses in the private sector. The policies that were introduced were as follows:

- i) Reduce the current account deficit to 3 percent of GNP in 1998.
- ii) Trim Federal Government expenditure by 18 percent in 1998.
- iii) Stricter criteria for approvals of new reverse investment, and deferred the implementation of non-strategic and non-essential projects.

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IV. MEASURES TAKEN TO ADDRESS THE CRISIS

A. INTRODUCTION

Malaysia introduced a series of policy packages to address the crisis. The policy measures evolved according to the changing environment during the course of the crisis. The initial approach adopted contained some features of the IMF prescription for economies in the region although Malaysia was not under an IMF program.⁴⁷ While these measures were able to address certain concerns such as price pressures and the current account deficit in the balance of payments, they caused severe liquidity problems, reduced accessibility to credit and thus, adversely affected the performance of the private sector and in turn contributed to strains on the economy. Coupled with the weak external demand and prolonged uncertainty in the regional economies, it resulted in a rapid contraction of the economy.

The Government consequently decided to change its course of action by relaxing the fiscal and monetary policies in mid-1998. It also continued to fine-tune its policies in order to strengthen economic and financial sector fundamentals and restore domestic and external stability. The initial strong conditions in both the real economy and financial sector have allowed Malaysia to exercise greater flexibility and provided greater scope for designing pragmatic policy measures.

⁴⁷ Malaysia, Ministry of Finance, *The 1999 Budget Speech*, October 23, 1998, Kula Lumpur.

B. INITIAL STAGE – TIGHT MONETARY AND FISCAL POLICIES, AND FINANCIAL SECTOR RESTRUCTURING

During the initial phase of the crisis, macroeconomic policy focused on addressing key areas of vulnerabilities, in particular, containing inflation and excess domestic demand manifested by rapid credit growth and the current account deficit in the balance of payments. At the same time, maintaining the standard of living and export competitiveness were key priorities. Policies with respect to the financial sector were intended to strengthen its resilience so as to avoid systemic risks.

The tight monetary policy, which was in place before the crisis was further, tightened. Interest rates were adjusted upwards to be in line with the expected higher rate of inflation to ensure a positive rate of return to savers. Among the other measures were the introductions of a credit plan to limit loan growth to 25 percent by the end of 1997, 20 percent by the end of the first quarter of 1998 and 15 percent by the end of 1998.⁴⁸ Central Bank further curbed loans growth by introducing more stringent guidelines on conditions relating to hire-purchase loans for non-commercial passenger vehicles and lending to the property sector excluding low- and medium-cost residential properties, factories and industrial buildings. In respect of fiscal policy, the Government reduced its expenditure and deferred implementation of selected infrastructure projects. This was intended to reduce imports as well as address the issue of excessive credit growth and the high leverage of some corporations. The Government, however, ensured that budget

⁴⁸ Malaysia, Ministry of Finance, *1998 Budget Speech*, October 17, 1997, Kuala Lumpur.

allocations related to the quality of life, particularly with respect to health, education and the provision of other basic amenities, were maintained.⁴⁹

With regard to the financial sector, prudential regulations of the financial system were adjusted in an untimely fashion to be in line with international standards. This included reclassifying NPLs as loans that have been in arrears for three months compared with six months previously, increasing the rate for general provisioning and requiring greater financial disclosure by banking institutions. Central Bank also continued to pursue its merger program for finance companies.

The combination of a tight monetary policy, fiscal restraint and the financial sector restructuring measures introduced during the initial stage of the crisis brought negative results instead. The measures, while succeeding in containing price pressures as well as reversing the current account of the balance of payments from a deficit to a surplus position, accentuated the cash flow problems of businesses already affected by the depreciation of the ringgit, decline in the stock market and weak external demand. They severely dampened private sector activity and contributed to the rapid contraction of the economy.

C. NATIONAL ECONOMIC RECOVERY PLAN (NERP)

The NERP, which was launched in July 1998, provides a comprehensive framework for economic recovery, including steps to counter the negative effects of the

⁴⁹ Ibid.

ringgit depreciation and stock market collapse. The National Economic Recovery Plan criticizes cronyism and nepotism, which has often characterized Malaysian Institution and it develops an argument for reform that aims at eliminating these practices. Its "Plan for Action" set six objectives namely to stabilize the ringgit, restoring market confidence, maintaining financial stability, strengthening economic fundamentals, continuing the equity and socioeconomic agenda and restoring adversely affected areas.⁵⁰ The NERP focuses the attention and effort of the whole nation to pursue a consistent line of action for recovery. The recommendations include wide-ranging proposals for economic stabilization and structural reforms as well as address socio-economic priorities and sectors affected by the crisis. High on the priority list are actions to restore stability in the currency and capital markets, as well as to strengthen financial markets and economic fundamentals. The NERP also recommends the easing of fiscal and monetary policies as well as lowering the cost of capital to revitalize the economy. To date, its recommendations are at different stages of implementation by the relevant agencies, closely monitored by the National Economic Action Council (NEAC), with the release of progress reports to the public periodically.

⁵⁰ Tokyo – Mitsubishi Review, *Current Malaysian Economy and Issues under New Capital Control*. Available http://www.btm.co.jp/html_e/databank/rev9903e.htm

1. Stabilizing the Ringgit

Since the start of the currency crisis, the ringgit has been very volatile, fluctuating by the day. There are many external and internal forces influencing the exchange rate. The wider the exchange rate fluctuates, the more would businesses and individuals have to hedge against future ringgit movement in order to reduce the risk.

Since June 1973, Malaysia has adopted the flexible exchange rate regime. Bank Negara exercises the option to intervene when deemed necessary in order to even out sharp exchange rate fluctuations. Since mid-July 1997, Central Bank had allowed the ringgit to be determined by market forces, but started intervening again in early January 1998, in order to stop market panic, following the free fall of the rupiah. The basic argument in favor of flexible exchange rate is that an economy can adjust easily to external shocks. In addition, monetary policy can be used for domestic ends, such as price stability, rather than having to use interest rates to keep the exchange rate on target. The most important disadvantage is that flexible exchange rates can be volatile and, on occasion, grossly misaligned. This can hinder trade and upset the economy.

Although 18 percent of Malaysia's overall trade is with United States, about 70 percent of its trade settlements are conducted in the US dollar, which is appreciated against most currencies. Only about 15 percent of Malaysia's total trade settlements are in ringgit and 6.5 percent in yen. There is a need to reduce an over-dependence on the US

dollar in Malaysia's trade with other countries and build up reserves of different foreign currencies.⁵¹

Although currency attacks cannot be entirely prevented, large external reserves can help to deter such attacks from occurring. The increased reserves will enhance the country's "war chest" for confidence building in the ringgit. The government recognized the problems associated with low interest rates. Low interest rates will allow the banks to delay the balance sheet adjustment, but liquidity will be frozen in non-performing assets. The lack of value adjustment will prevent market clearing and limit investment opportunities for both local as well as foreign investors. In the initial stage, low interest rates will lead to credit growth of the poorest quality (distress borrowing), adding to bank's NPL problems. Over time, a weak economy and ongoing bad loan problems will make bank reluctant to extend new loans, leading to credit crunch despite low interest rates.

On the other hand, some arguments have been forwarded against high interest rates. Many businesses, even well managed one, will fail if the interest rates continue to increase, resulting in recession. The poorly managed businesses have already been punished by the market, but why kill off the good company? High interest rates will not necessarily attract inflow of funds. In the face of currency volatility, investors are more attracted to currency stability and value appreciation than interest yield. High interest rates may not really encourage domestic savings if the ringgit is weak. The rich could

⁵¹ National Economic Action Council, *National Economic Recovery Plan: Promoting Market Stabilization, Stabilizing the Ringgit*, Kuala Lumpur, 1998.

always park their money offshore. High interest rates is often regarded as more risky and a symptom of weakness in the economic system.

In view of the above, the government should adopt the balanced approach to interest rates since a sharp and prolonged increase in interest rate would be untenable. This would fuel inflationary expectations through higher cost of funds. Nominal interest rates should be kept above the inflation rate so that the real interest rate does not become negative. This is to ensure that savers receive positive rate of return for their deposits, and funds do not go offshore to search for higher returns. While interest rates are allowed to rise to underpin currency stability, care should be taken that they are not prohibitive and damaging to the private sector.

2. Restoring Market Confidence

The persistence of the currency crisis has been prolonged by the weakening of confidence. Restoring market confidence is an important step to stabilize and strengthen the currency. There is a need to address some fundamental issues that have affected the market confidence. The public is concerned about inconsistent policy announcement that has given rise to uncertainty and confusion. In addition, there are calls for increase corporate transparency. The Malaysian public and foreign investors need to be reassured that the regulators are committed to the open market and fair dealings. The minority investors must also be fairly protected.

Malaysia has four proposals for achieving goal of restoring market confidence i.e. establishment of fair stock trading and strengthening supervision, clarification of the

standards under which the government will step into the bail-out companies with public support, regular publication of economic statistics and improvements in the dissemination of information to other countries. Malaysian authorities should make an effort early to exchange an opinion with foreign investors and to develop close and cooperative relations with the World Bank and IMF. Any time there is significant change in systems that affect the markets, the markets should be given sufficient time after the announcement to prepare.⁵² Transparency and consistency of government policies allow various parties to make informed investment decisions and bring fewer market surprises. The public would be reassured that the banking system is still resilient despite the increasing corporate difficulties.

3. Maintaining Financial Market Stability

During the rapid growth of the 1990s, many banks and depository institutions were able to manage high loan growth and generate significant fee income, while building a productive asset base, increasing profits, making provision for losses, and expanding their capital base. Since the start of the regional contagion effect, the Malaysian banking system has been under considerable constrain following the collapse in the stock market and the depreciation of the ringgit. The relatively high leverage coupled with the heavy reliance on short-term debts increases the overall solvency risk profile of both corporate and financial sector, especially when the rates are increased. The ratio of the non-

⁵² Tokyo – Mitsubishi Review, *Current Malaysian Economy and Issues under New Capital Control*.

performing loans (NPL) has risen from 3.5 percent in March 1997 to 9.1 percent in March 1998. In the environment of rapid economic growth, the corporate sector would be able to service the increasing amount of debt through increased cashflow. However, with falling economic growth, the corporate sector would face increasing problems in servicing their debts, especially when coupled with liquidity squeeze, a credit crunch, and an asset price deflation.

The government has introduced various measures to reform the financial sectors. This includes strengthening finance companies through assisted merger, pre-emptive recapitalization of core banking system, greater disclosure of information to facilitate better market judgements, and strengthening of prudential regulation and supervision. However, some additional policy measures are required to strengthen the financial markets. The stabilization of the financial market is an important condition to restore market confidence. Weakness in financial sector should be given urgent attention. Weak but viable institutions should be restructured and recapitalized. The government has identified various actions to bring stability in the financial market as follows:⁵³

Preserve the integrity of the banking system by closer surveillance of banks and the improvement of non-performing loans, encouraging bank mergers, and addressing worsening collateral and non-performing assets.

⁵³ National Economic Action Council, *National Economic Recovery Plan: Promoting Market Stabilization, Maintaining Financial Market Stability*, Kuala Lumpur, 1998.

Recapitalize the banking sector. The estimated total non-performing loan in the banking system was around RM 74 billion at the end of 1998 and RM 100 billion at end 1999. The government issued RM 20 billion worth of long-term bonds and injected the funds into the banks.

Monitor closely overall credit expansion through more flexible implementation of the overall Credit Plan target and developing a bond market for large infrastructure projects.

Improve the capital market by strengthening the regulatory framework and addressing the weaknesses of market participants and activities.

4. Strengthening Economic Fundamentals

The issues are structural in nature, and the measures are aimed at instituting structural reforms that would set in place a more dynamic and resilient economy. One of the areas of concern before the currency attack is the persistence of current account deficit in the balance of payments. During the 1990s, the current account deficit was around 5 percent of GNP, except for 1991, 1994 and 1995 when the deficit rose to 8-10 percent. This means that Malaysia has a saving-investment gap that has to be financed with foreign savings. The nature of foreign funds, whether in the form of short-term portfolio funds or foreign direct investments, can affect the country's vulnerability to a sudden withdrawal of funds. The sharp increase of short-term private capital inflow during 1995-96 exposed Malaysia to such a risk. The negligible contribution of productivity to growth is consistent with the finding that Malaysia's

incremental capital output ratio has been rising in recent years, which means that capital is used less efficiently in the country. There is an urgent need for the authorities to prioritize large-scale investments required high import content since this would require a significant amount of capital and placed the external balance under pressure. Care should be taken to reduce low priority infrastructure facilities and improve productivity of investment by cutting wastage and cost.⁵⁴

The current account of the balance of payments is an indicator of economic resilience, which influences investor confidence. A persistence current account deficit implies that the investment and the consumption of the country have consistently been above its available resources, thereby making it increasingly dependent on foreign capital. If the foreign capital inflows are insufficient to finance the current account deficit, the value of the external reserves will fall, which raises the concern about the long-term strength and the stability of the economy. Necessary actions were taken to improve the balance of payment by according greater importance to the development of resource-based industries in order to encourage activities with low import content. The development of backward linkages for the non-resource based industries were accelerated in order to encourage local sourcing of inputs. Technological advancement through research and development was also carried out to encourage innovation and invention of capital goods for the manufacturing sector.

⁵⁴ National Economic Action Council, *National Economic Recovery Plan: Strengthening Economic Fundamentals*, Kuala Lumpur, 1998.

There has been tightening monetary policy to moderate the rate of loan growth. The policy of reducing the rate of loan growth from a high to moderate level is bound to cause some painful adjustments in some industries. Lowering the interest rates sharply could cause the exchange rate to weaken further, which could lead to an outflow funds and push up interest rates. Appropriate monetary policy need to be maintained. It is important to keep the credit growth in line with the microeconomic outlook, productive activities should continue to receive financing support and working capital. The availability of finance is essential for the businesses to continue generating economic activities as well as to avoid unnecessary business failure due to lack of access to funds.⁵⁵

Maintaining low inflation is critical for ensuring Malaysia's competitiveness, stability in the ringgit, and improvement in the standard of living. In this regard, the government is strongly committed to non-inflationary policies. To control inflation in the short run, appropriate monetary policy would be adopted together with stricter enforcement and price check by relevant authorities to ensure regular supply of goods. Currently, a total of 21 goods are classified as controlled items and another 25 goods are classified only on the festive seasons. The control items account for about 10.5 percent of the total weight in the consumer price index. Measures to break down inflationary expectations that were adopted includes enhancing domestic competition through further deregulation and privatization, phasing out the remaining import and marketing

⁵⁵ Malaysia, Ministry of Finance, *The 1998 Budget Speech*, October 17, 1997, Kuala Lumpur.

monopolies, and phasing out the remaining non-tariff barriers and allow competitive imports.

Enhancing Malaysia's competitiveness is essential in the face of intense global competition and changing consumer markets. The country currently endowed with a stable political climate, favorable economic environment, supportive regulatory regime and the availability of an educated, adaptable and trainable workforce. To take advantage of these favorable conditions, public and private sectors should work towards increasing productivity and efficiency, which would help to sustain higher wages and household income.

5. Continuing the Equity and Socio-Economic Agenda

The economic crisis has badly affected household income, employment opportunities, and the public share ownership. As less Malaysian go overseas for studies, there is a need to expand tertiary education to satisfy the surge of local demand. State corporations and cooperative have to be revamped in order to be more focus in their activities. The commitment to preserve the environment should continue despite the pressure of reduced financial resources in the public and private sectors.

The government has adopted measures to increase opportunities for employment as well as to contain price increases especially food items. To expand the employment opportunities the government has created more investment in export-oriented industries that require highly skilled labor and self-employment. There are about 800,000 illegal worker with 400,000 dependants in the country. The government has taken measures to

control the influx of foreign workers by reviewing the policies and strategies on foreign workers. Those who cannot be re-deployed has been repatriated, and there is a strict enforcement of the Immigration Act where foreign labor are charged market rate for using local education and health facilities.⁵⁶

6. Revitalizing Affected Areas

The crisis has wide ranging implication on sector performance and prospects. Many sectors have been adversely affected by rising cost, falling demand, financing problems, and mounting debts. The industries that have initiated expansion programs in previous years are now faced with excess capacity and underutilized equipment and manpower. The primary commodities sector comprises of rubber, oil palm, forestry and other minor crops such as cocoa and tobacco. In 1997, the sector accounted for 8 percent of the country total exports of RM 115 billion and 10.5 percent of total export earnings of RM 221 billion. Malaysia is losing competitiveness in natural rubber due to higher production cost and wage levels, as well as the higher rate of depreciation of rupiah and baht. The export value of palm oil is sensitive to exchange rate fluctuations. A change of US 1 cent in rate means a difference of RM 38 million in export value. Further price increases in the palm oil could force substitution to other oils. Palm oil is sold at USD 678 compared with USD 634 for soya oil and USD 640 for rapeseed oil. The subsector is also faced with higher cost of imported fertilizers and labor shortage.

⁵⁶ National Economic Action Council, *National Economic Recovery Plan: Continuing the Equity and Socio-Economic Agenda*, Kuala Lumpur, 1998.

To revitalize this area the government has reviewed the funding for rubber replanting with the view to sustaining rubber output, raised smallholder incomes as well as ensuring stable supply of rubber wood to the furniture industry. The government has also established bilateral payment arrangements with non-traditional markets such as China, the Middle Eastern Countries that offer good prospects for the export of Malaysian primary commodities and resource-based products.⁵⁷ Similar actions have been taken to other affected sectors such as Mining and Petroleum, Manufacturing, Information Technology and the Multimedia Super Corridor, Motor Industry, Construction, and others.

D. EASING MONETARY AND FISCAL POLICY

Beginning mid-1998, the policy focus shifted towards preventing any further contraction of the economy, reactivating economic growth and ensuring the continuation of socio-economic projects so that the living standards, particularly of the poor and lower income group, are not adversely affected. Appropriate steps were also taken to strengthen the financial system. To prevent any further contraction of the economy, the Government eased its monetary and fiscal policies. These actions were taken after noting that demand pressures were absent, the inflation rate and monetary growth were beginning to decelerate and ringgit exchange rates were relatively stable with fluctuations reflecting mainly external developments.

⁵⁷ National Economic Action Council, *National Economic Recovery Plan: Revitalizing Affected Sectors*, Kuala Lumpur, 1998.

As part of the efforts to ease monetary policy, Central Bank reduced the intervention rate on which interest rates are based from 10 percent to 9.5 percent and cut the statutory reserve ratio to 6 percent from 5 percent in order to inject liquidity into the debt-ridden banking system.⁵⁸ With respect to fiscal policy, the Government has taken steps to boost growth through fiscal stimulus. As such, the Government has changed its fiscal stance from a surplus to a deficit budget. The Government has increased the 1998 budget allocation by RM 7 billion, in particular, to finance development project. As part of the efforts to provide funding to companies undertaking infrastructure projects which require large capital outlay, the Government restructured Bank Pembangunan Malaysia Berhad (Development Bank) to form Bank Pembangunan dan Infrastruktur Malaysia Berhad (Development and Infrastructure Bank) with a paid-up capital of RM1 billion.⁵⁹ While introducing the stimulus package, the Government will remain cognizant of the need to maintain fiscal prudence. This fiscal stimulus package will result in the overall public sector account registering a manageable deficit of 1.8 percent of GNP in 1998 and 5.5 percent in 1999. This package focuses on selected projects with strong linkages to the economy to ensure maximum stimulus to economic growth, minimal leakage in terms of imports, short gestation period while meeting socio-economic objectives. At the same time, the Government will ensure that the implementation of this package will not exert pressure on prices. In this respect, the projects given priority are housing, education,

⁵⁸ Prema-chandra Athukorala, "Swimming against the tide: Crisis Management in Malaysia".

⁵⁹ Malaysia, Ministry of Finance, *The 1999 Budget Speech*, October 23, 1998, Kuala Lumpur.

health, rural development and infrastructure.

In order to further promote FDI, the Government liberalized the equity policy for the manufacturing sector. The Government also relaxed the 30 percent limit imposed on foreign ownership for several domestically-oriented activities such as telecommunications, shipping and forwarding, insurance, hotel and tourism as well as approved activities in the Multimedia Super Corridor (MSC). Foreign investment guidelines were also relaxed to allow greater opportunities for property ownership by foreigners.

E. FINANCIAL SECTOR RESTRUCTURING

The Government undertook measures to strengthen the resilience of the financial sector in order to avoid systemic risks and ensure the continued efficient functioning of the intermediation role of the banking system, which is crucial for economic recovery. Measures were, therefore, introduced to restructure and consolidate the financial sector, with the aim of relieving the banks of their non-performing assets, strengthening and recapitalizing banking institutions, improving the efficiency of the intermediation process and facilitating corporate debt restructuring. Among the measures were the discontinuation of the tiering system for banking institutions and the setting up of Asset Management Company (Danaharta) to manage the non-performing loans (NPLs) of the financial institutions. Its main objective is to remove the NPLs from the balance sheet of the financial institutions at fair market value and to minimize their recovery value. This

will free the banks from the burden of debts that had prevented them from providing loans to their customers.

As the capital base of banks has been affected by the decline in share prices and NPLs, these banks need to be recapitalized. For this purpose the special purpose vehicle (Danamodal) was set up to capitalize and consolidate the banking sector, i.e., to inject capital into banks facing difficulties. The injection of capital will enhance the resilience of banks, increase their capacity to grant new loans and consequently speed up the economic recovery process.⁶⁰

To complement the restructuring of the financial system by Danaharta and Danamodal, the Corporate Debt Restructuring Committee (CDRC) was set up in August 1998 to facilitate the structuring of viable companies. The aim is to minimize losses to creditors, shareholders, and other stockholders. This also to avoid placing the viable companies into liquidation or receivership, and to enable banking institution to play a greater role in rehabilitating the corporate sector. The CDRC adopts a constructive approach and framework to enable creditors and debtors to devise and implement workout plan without resorting to legal procedures.⁶¹

⁶⁰ Sulaiman Mahbob, "National Economic Recovery Plan and the role of the National Economic Action Council" (Presentation at the 21st MAJECA-JAMECA Joint Conference, March 10, 1999, Kuala Lumpur, Malaysia).

⁶¹ Victor Wee, "Malaysia's Experience in dealing with the Financial Crisis" (Presentation at the Securities Association of China and Asian Securities Analyst Federation Joint Seminar, 28-30 June 1999, Dalian, China).

F. SELECTIVE EXCHANGE CONTROL

In terms of the overall macroeconomic framework, Malaysia had by August 1998, contained inflation, improved its external balance and maintained low external debt exposure. At the same time, Malaysia had ascertained its external reserves remained intact and ensured the banking sector continued to perform its intermediation function. Despite these positive trends, Malaysia continued to remain vulnerable to external developments. There remained continued risks of further waves of instability in the regional financial markets. Despite the measures and reforms that were put in place by the affected countries, signs of stability did not return to their financial markets. Malaysia's call for an international financial architecture to regulate short-term flows and currency trading at various international fora remained largely unheeded.

On its part, Malaysia introduced adjustment policies and implemented financial reforms to reduce the risks and vulnerabilities to external developments. While these measures are on going, their prospects to yield the desired results can only be achieved in a stable environment. A source of concern that emerged during this period was the increase in the rate of internationalization of the ringgit. This trend became increasingly apparent since April 1998 and was reflected by increasing outflow of ringgit as opposed to other foreign currencies. The ringgit outflow was attracted by higher interest rates in the region of 20 to 40 percent offered by offshore centers while onshore rate was only

about 11 percent.⁶² The strong demand for offshore ringgit at high costs and the build-up of offshore ringgit increased its vulnerability. In view of the openness of the Malaysian economy, this trend could cause fundamental damage to the real economy and affect the country's ability to conduct appropriate monetary policy based on domestic conditions. As a result of these developments, Malaysia announced the introduction of selective exchange control measures to eliminate volatility in the ringgit and control short-term capital flows on 1 September 1998.⁶³

Specifically, only the following items are controlled:

- i) Ringgit-denominated transactions among non-residents via non- resident external account;
- ii) Outflows of short-term capital by requiring such inflows to remain in the country for a minimum period of one year;
- iii) Import and export of ringgit by travelers, both residents and non-residents; and
- iv) Malaysian investments abroad which now require approvals as there is insufficient funds to be taken out. Capital may, however, be raised abroad, collateralized by foreign assets.

There are no controls on:

⁶² Ali Abul Hassan Sulaiman, "Towards Revitalizing the Asian Economy" (Presentation at the Japan-Malaysia Association Symposium, September 7, 1999, Tokyo, Japan).

⁶³ Bank Negara Malaysia, *Measures to Regain Monetary Independence*, September 1, 1998, Kuala Lumpur.

- i) Current account transactions (amendment to rules only require trade transactions, both for goods and services, to be settled only in foreign currencies and no longer in domestic currency);
- ii) Repatriation of interest, dividends, fees, commissions and the rental income from portfolio investment and other forms of ringgit assets; and
- iii) FDI inflows and outflows, including income and capital gains.

The exchange control measures adopted were designed and implemented to achieve specific objectives. The basic objective of the exchange control was to insulate the Malaysian economy from external shock and to provide an environment of stability to facilitate the ongoing economic and financial reforms. These measures are selective and are aimed specifically at eliminating access of speculators to the ringgit through the reduction of the ringgit in offshore markets, thereby limiting its supply to speculators. These controls were also aimed at stabilizing short-term capital inflows, by requiring such inflows to remain in the country for a minimum period of one year.

Malaysia's exchange controls are therefore selective, designed to achieve the specific objective of containing speculative capital. The new exchange control measures did not affect the normal conduct of economic activity. They continue to guarantee general convertibility of current account transactions and the free flow of the foreign direct investments. Malaysia welcomes long-term foreign direct investments, which bring technology, skills and market access, but is guarded about the flow of hot money, which

increases the country's vulnerability.⁶⁴ The ringgit was pegged at RM 3.80 to US dollar. The measures effectively make the ringgit non-tradable outside the country in order to stabilize the ringgit, bring offshore ringgit back to the country, and reduce the ability of non-residents to trade in ringgit. In order to ensure the effective operation of the capital control measures, the unlicensed bourse trading of Malaysian equities outside the country was terminated in order to prevent leakage. The Central Limit Order Book International (CLOB) was closed down on September 15, 1998. There is also twelve months holding period for foreign portfolio investment.⁶⁵ However, on 4 February 1999, the rule on the one-year holding of portfolio capital was modified to allow foreign investors to repatriate the principal capital and profits, subject to a graduated levy depending on when the funds were brought into Malaysia and the duration of the investment.⁶⁶ The amendments continue to encourage investors to take a longer-term view of their investments in Malaysia and discourage destabilizing short-term flows.

Overall, the Government adopts a flexible approach in the implementation of the new exchange control rules and the situation is being closely monitored. Emphasis is placed on the efficiency of the implementation process as well as the dissemination of information on this exchange control rules to provide a greater understanding. The

⁶⁴ Daim Zainuddin, "Economic and Financial Crisis – Malaysia's Response" (Presentation at the Economic Law Forum, 3-5 December 1998, City University of Hong Kong).

⁶⁵ Victor Wee, "Malaysia's Experience in dealing with the Financial Crisis".

⁶⁶ Sulaiman Mahbob, "National Economic Recovery Plan and the role of National Economic Action Council".

administrative machinery is in place to provide prompt responses to requests, thus minimizing disruptions and inefficiencies.

Malaysia's decision to adopt capital controls was initially greeted with scorn and skepticism internationally. But the critics now recognized that these controls gave the country the breathing space to implement a well-design strategy for the financial and corporate sectors. The concern that Malaysia may use capital controls to delay addressing problems in the financial and corporate sectors has also diminished. The World Bank has reversed its opposition to short-term capital controls and has announced that Malaysia's experiment with capital controls was in effect a success.⁶⁷ This endorsement by the World Bank means that conventional wisdom now says that capital controls are legitimate tool in economic policy.

The capital control measure taken by Malaysia is just a short-term measure. The currency peg has been a major help in the recovery process. It allowed the government to break the link between the interest rates and the exchange rates, thus allowing Malaysia to lower interest rates without sending the Ringgit into another downward spiral. The Malaysian exports were more competitive and became cheaper in US dollar terms. Imports became more expensive in Ringgit terms. This reduction in imports and increase in exports turned the current account of the balance of payments a surplus. The cheaper Ringgit brought in more foreign tourists. Malaysians found it expensive to holiday abroad and adopted for local holiday sites. Labor costs in US dollar terms were cheaper, making

⁶⁷ "World Bank: Capital Controls not disastrous," *Business Times*, June 23, 1999.

the country more attractive for investment in export-oriented industries. The currency peg has given Malaysia stability, but there is not enough certainty for a review of a rate. There have been significant movements in the baht, peso, and rupiah that create unpredictability, forcing Malaysia to retain the peg. Malaysia is not prompted to make any changes to the peg for the time being.

V. LESSONS LEARNED AND CONCLUSION

A. LESSONS FROM THE CRISIS

The current crisis shows that while there are benefits of being part of the global economy, there are also serious risks such as instability of global financial markets, contagion and magnification of mistakes. In a world of increasing capital mobility, large capital inflows can bring substantial instability to economies.

One of the great lessons of the crisis is the critical importance for developing countries to properly manage the interface between global developments and national policies, especially in planning a nation's financial system and policy. In a rapid globalizing world, developing countries face tremendous pressure which comes from developed countries, international agencies and transnational companies to totally open up their economies. In some cases and under certain conditions, liberalization can play and has played a positive role in development.⁶⁸

However, the crisis experienced by Asian countries has shown up that in other circumstances, liberalization can wreak havoc, especially in small and independent economies. This is especially so in the field of financial liberalization, where the lifting of controls over capital flows can lead to such alarming results as a country accumulating a mountain of foreign debts within a few years. The sudden sharp depreciation of its

⁶⁸ Martin Khor, *The Economic Crisis in East Asia: Causes, Effects and Lessons*. Available at <http://www.visionews.com/visionews2/intl/text/four.htm>

currency and a stampede of foreign-owned and local-owned funds out of the country in a few months. It is clear from the Asian crisis that it is prudent and necessary for developing countries to have measures that reduce its exposure to the risk of globalization and thus place limits on its degree of financial liberalization.

At the macro policy level, a very critical lesson from the crisis is that government has to pay great attention to external debt management. The government has to take great care to limit the country's foreign debt. It was the rapid build-up of the external debt than anything else that led to the crisis in Thailand, Indonesia, South Korea and Malaysia. Developing countries should not build up a large foreign debt whether public or private debt, even if they have relatively large exports earnings. However, a bitter lesson of the crisis is that high current export earnings alone are insufficient to guarantee that debt can be serviced. For a start, future export growth can slow down. Then, there can also be a high growth in imports and large outflow of funds due to repatriation of foreign-owned profits or due to the withdrawal of short-term speculative funds.⁶⁹ In good years these factors can be offset by large inflows of foreign long-term investment. However, if the negative factors outweigh the inflows, the balance of payments will register a deficit. Such deficits mean that the country's foreign reserves are being run down. When the reserves are not large enough to adequately pay for the interest and principal of the external debt that is due, the country has reach the brink of default and thus has to declare a state of crisis requiring international assistance.

⁶⁹ Ibid.

Having a large foreign debt puts a country in a situation of considerable risk, especially when a country has liberalized and its currency is fully convertible and thus subject to speculation. In particular having too much short-term debt can be dangerous as it has to be repaid within a short period of months or a year, thus requiring the country to have large enough reserves at that period to be able to service the debts.⁷⁰ It is thus important to watch the relation levels of debt and debt servicing not only to export earnings but also to the level of foreign reserves. Reserves should be built up to a comfortable level, sufficient to service debt, especially short-term debt.

The international orthodoxy in recent years of the benefits to developing countries of having a financially open system is now crumbling in light of the extremely high costs being paid by countries that opened up and saw sudden entry and exit of foreign funds. A new paradigm is emerging that grants that developing countries should have the right to impose capital controls to protect their interests and to enable a degree of stability. A major lesson of the crisis is that capital control should be seen as a normal, acceptable and indeed valuable component of the array of policy options available to promote development.⁷¹

The causes and consequences of the crisis differ across countries and cannot be explained in terms of a single set of factors. The experience suggests that we must see the countries as different strands and proposals on how to tackle the crisis must be

⁷⁰ Ibid.

⁷¹ Mahathir Mohamad, "Why Malaysia's Selective Control are Necessary" (Speech at the Symposium of the First Anniversary of Currency Control, November 2, 1999, Kuala Lumpur, Malaysia).

correspondingly be different. Strong fundamentals by themselves provide insufficient protection against financial crisis. Contagion can spread rapidly to other countries irrespective whether they have strong economic fundamentals.⁷² So, if a developing country opens up its financial sector before it is ready, it opens itself to the vagaries of tremendous shocks and instability associated with inflows and outflows for funds.

The crisis also shows that sentiments rather than fundamentals drive financial markets. This makes the market inefficient. The current crisis has also shattered the myth of perfectly working financial markets and its efficiency in the allocation of resources. It shows that markets are inefficient as seen by the huge inflows and then sudden outflows of foreign funds. The experience also shows that the financial deregulation measures taken in recent years were premature on the assumption that markets companies and banks behave rationally and efficiently. Governments at the least should have strong regulations to prevent the private sector from making mistakes, especially in relation to foreign currency loans.

It is an illusion to consider short-term capital flows as a free market activity. The combination of financial deregulation and speed of transactions through computer technology with the surge in speculative hedge funds has led to short-term capital flows millions of dollar. Only small amount of this is generally accounted for by foreign exchange transactions related to trade and foreign direct investment. The control of short-term capital is in the hands of a relatively small number of heavily backed hedge funds.

⁷² Govindan K., "Malaysia's Economic Recovery" (Presentation at the Annual Conference for CIMB Securities Domestic Fund Managers, 12-14 November 1999, Penang, Malaysia).

These people are capable of creating oscillations that become uncontrollable. Even countries with sizeable foreign reserves cannot fight the formidable hedge funds. There is no international body capable of dealing systematically with the institutions, markets and problems associated with the highly volatile and huge capital flows of international capital.⁷³ There is lack of transparency on what constitutes the financial markets, who the major players are what are their devices and how money is moved from market to market. We need to know whom the major institutions and players are in the ownership of financial assets, their behavior and operational methods.

In formulating policy measures to deal with financial crisis, it is important to make an assessment on whether conditions are present to ensure the success of policies. The policy response in Asia should have been tailor-made to suit each country's structure and circumstances. Most importantly, the response should have aimed at ensuring that the underlying strength of the real economy can be preserved so that it can return to the path of recovery. It is important to note that the policy prescription that works for one problem cannot be replicated as a recipe for success in another situations. Malaysian experience is that policy prescriptions cannot be rigid and inflexible.⁷⁴ They have to adapt with changing dynamics, as long as long-term objectives are not undermined. The IMF policy prescription that may have worked in other countries, such as Mexico, did not work in Malaysia. Exchange control should remain one of the policy options, but it should not be

⁷³ Ibid.

⁷⁴ Ali Abul Hassan Sulaiman, "Towards Revitalizing the Asian Economy".

substitute for sound macroeconomic policies. The Malaysian experience has shown the selective and carefully crafted exchange controls, when used to complement conventional macroeconomic policies, can contribute to economic stability. The controls do not imply that Malaysia has disengaged itself from the market system.

Social dimension should be taken into consideration in formulating any policy response. Malaysia relaxed its fiscal and monetary policy stance and complemented these with selective capital controls to restore stability and mitigate the impact of the crisis on the poorer segment of the society.⁷⁵ The Malaysian approach to the financial crisis did not include the unrelated measures. For example, the policy package did not include measures to remove the subsidies on oil and other essential goods, as this would have an adverse impact on the poor. In a crisis, the policy response must be sequenced properly to ensure the market can absorb it. Overall, Malaysian pragmatism in formulating short-term strategies, while remaining focus with single-mindedness on the long-term objectives, and looking beyond economic prescriptions, have serve Malaysian well in managing the crisis.

The powerful changes occurring in the information and communication technology will make international financial transactions quick and difficult to track. The problem is how to ensure the benefits of capital mobility exceed its costs. As shown by recent experience, the existing international financial structure is inadequate to deal with the developments in the global scene. At the minimum, reforms should put in place some

⁷⁵ Ibid.

mechanism to control short-term capital flows. Some form of early warning system in currency and banking crisis could help. But such a system should be preemptive rather than like the Richter scale that shows crisis after it occurs.

A national level approach is insufficient to deal with future crisis. It must be a global approach to monitor and regulate cross-border financial flows to reduce the volatile inflows and outflows of short-term capital. Full liberalization of the financial system should only come when the country is prepared for the risks of destabilizing capital inflows and outflows. The pace of liberalization should be at a gradual pace in line with the growth of expertise and capacity.

B. CONCLUSION

The economic crisis, which has battered the Southeast Asian region and other part of East Asia, is an unsettling crisis that can threaten the stability of the region and indeed other parts of the world if stabilization fail. Even with the best economic management, small open economies remain vulnerable. A small open economy is vulnerable to sudden changes in sentiment that could swing from irrational optimism to irrational pessimism. When there is instability of beliefs, there could be still the run of currencies even if countries have sound financial systems and good policies. If however, the countries are linked with weak financial sectors, high level of corporate debt, and lack of transparency, they become even more vulnerable to attacks. While it is not within the power of one country to prevent the occurrence of future attacks on currency, the

adoption of good policies would certainly make countries less vulnerable and the effect suffered less severe.

The recovery measures taken by the Government were to strengthen the ringgit and the financial system, as well as to improve the standard of transparency and corporate governance. These measures were intended to ward off the occurrence of future attacks, or at least minimize the severity of the adverse effects should such attacks occur. The general thrust of the various policy measures adopted by the Government is to restore business confidence and turn the economy around. The country's macroeconomic prospects is also dependent on external factors, such as restoration of exchange rate stability and business confidence, as well as the inflow of direct foreign direct investments. The results of these measures may not be felt immediately, since monetary and exchange rate policies often take sometimes to come into full effect. There is still considerable uncertainty about the depth and duration of the financial crisis.

The severity of Malaysia's economic problem can be made considerably worse with mismatches that can give rise to vicious cycle of low business confidence and reduced economic activities. These can result in retrenchments and reduced consumption, which in turn will dampen business confidence. During the economic downturn it is important to guard against becoming overly pessimistic about the future since irrational pessimism can prove to be self-fulfilling. It can lead to the vicious cycle of capital outflows, which results in currency depreciation and falling prices, worsen the stains on the private sector, increase bankruptcies, undermine the real economy and financial stability, thereby further weakening confidence.

It is worth to note that Malaysia's past track record of rapid economic growth over the past three decades, which had dramatically increased life expectancy, educational opportunities, and per capita income, while accelerating the process of poverty eradication and restructuring the Malaysian society. All these are the testimony to the indisputable success of the New Economic Policy and the National Development Policy. The economy has successfully been transformed from a traditional primary producer into a modern and competitive export-based manufacturing economy. The development of the Multimedia Super Corridor will help to develop Malaysia into an IT hub and ensure the widespread diffusion and application of IT within the country. There is little reason to doubt that the country will rebound from the current crisis and continue to forge ahead with renewed vigor toward the goal of Vision 2020. Given political stability and national unity, the policy adjustment measures that the country is currently adopting to strengthen the macro economy and improve the financial and corporate sectors will, in fact, prepare the groundwork for the economy to take on the challenges and seize the opportunities in the next millennia.

The socio-economic aspects of development have always been given importance in Malaysia's development strategy. During an economic crisis, these aspects have grown in importance in order to reduce the hardship arising from falling income and declining in employment opportunities. There is a need to address the issues of the Malay race equity ownership, which has been hit by the precipitous fall in share prices. There is a challenge of meeting the demand of places in the local tertiary institution, which has risen dramatically following the cutback of funding for and the high cost of overseas education.

In the wake of depressed economic conditions, it is crucial that state corporations and cooperatives are revamped and revitalized in order to reduce excesses and become more focussed in their activities. For the sake of current as well as future generations, the imperative for environment protection and sustainable development must continue and not be pushed aside as other priorities take center stage.

Malaysian success in dealing with the crisis so quickly and with minimum disruption was not by chance. It was due to strategic and flexible policy making. It also exemplifies the close understanding and cooperation between the Government, the private sector and society to address the crisis. There is still a lot more to be done. To be successful Malaysia must be able to sustain economic recovery and get the economy back to its pre-crisis level. The structural reforms in the financial and corporate sectors have to move ahead to face up to the challenges of globalization. Capital market needs to be developed to meet the growing demands for long-term capital and reduce the heavy and risky dependence on the banking sector for funds. The corporate sector needs to improve the efficiency through better governance that will help boost investor confidence and safeguard minority interests.

Malaysia has taken its own course of action to protect the economy. All the recovery measures taken by Malaysia especially on the capital control has shown a sign of recovery. Prominent economists, including Paul Krugman noted that the capital control has some beneficial effects. By fixing its currency at a relatively low rate of 3.8 ringgit to a dollar, Malaysia made its export extremely competitive. Its booming trade in computers and peripherals is major reason its economic output swung from negative statistics to 4.1

percent growth. World Bank senior advisor Dr Amar Bhattacharya has also commended Malaysia's selective capital control measures, which in some way had given the country a breathing space to pursue on its on-going economic related programs. Although Malaysia has recovered from the worst of the crisis, the recent financial crisis has been a lesson to address the structural weaknesses. The economy is overly dependent on external demand, while domestic demand in particular, that of the private sector is insufficient to support economic growth. The export base needs to be expanded and diversified to reduce the over dependence on a few exports of manufactured goods, in particular electronics and semiconductors. To sustain economic growth, the foundations of the economy must be balanced and sources of growth diversified.

Malaysia's experience in managing the recent crisis holds important lessons not only to policy makers, but also for the writers of economic history. There are many dimensions and permutations to traditional macroeconomics management beyond the standard fiscal, monetary and structural policies. The most important lesson is that one should not be afraid to change and try new approaches when the old ways prove to be ineffective. Malaysian approach was unconventional but comprehensive and forward-looking. Despite the initial criticisms, there have been encouraging results in Malaysia, and even the IMF has acknowledged that exchange control can be useful in specific circumstances. As the crisis has proven, there is no single Holy Grail. Malaysia as others in the region, will have to frame its own strategies to suit its own unique social and economic circumstances.

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